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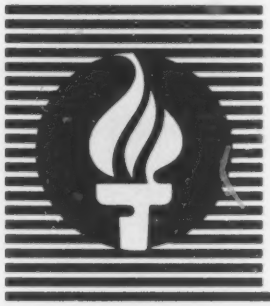

The Conference Board

Human Resources Outlook 1988

Labor market analysts see:

- *unemployment at 6% in first quarter, 6.3% by year-end*
- *average hourly earnings to rise 2.8%*
- *first-year wage and benefit increases in union contracts holding at 2.5%*
- *inflation at 4.1%*
- *recession unlikely in 1988, and...*
- *companies better prepared when it does come*

Research Bulletin No. 217

THE CONFERENCE BOARD'S 1988 HUMAN RESOURCES OUTLOOK

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The Conference Board's annual meeting of human resources experts took place on November 5, 1987. Panel members discussed the current economic situation, compensation trends, human resources developments, labor relations, and political events. This process provided the predictions for 1988 reported in Table 1. The views quoted were submitted by the participants in writing before the discussion.

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Human Resources Outlook 1988

by Audrey Freedman

The Human Resources Outlook panel, meeting several weeks after the stock market crash, does not expect an economic crash of similar proportion in 1988. That is not to say that this group of practitioners and academics is not concerned about the economy's signs of weakness. But focusing on human resources leads panel members to a more positive view of the U.S. economy's strength than they would adopt if financial or fiscal matters were their primary expertise. Within the general prediction of "no serious recession in 1988" there are mildly divergent views: two members foresee a tightening of the labor market in 1988, with some labor shortages; three members clearly expect recession to set in gradually—starting now (see Table 1).

These differing views about the timing of a business downturn affect most of the other subjects covered in this report, with one exception. The members unanimously think that human resources management has become more responsive to individual business needs, using labor resources cost-effectively and flexibly. As a result, business will approach the next recession with more "survival skills" and in better shape than in previous cycles. The increased flexibility also suggests that cost cutting, when necessary, will be swifter and sharper. The same techniques that were developed for "downsizing" and restructuring industries newly exposed to competition can also be used to adapt to recession.

The panel expects more interest and public support for social measures that are directed toward security for individuals. The contradictory needs for individual security and for economic flexibility underlay a great deal of our discussion. While no one anticipates a return to the rigidities of wage formulas and employment security policies, most panel members identify some needed controls on rough-and-tumble labor market competition. Thus, the discussion below turns to minimum wages, plant closing regulation, health insurance coverage, use of contingent workers, and risk-controlling strategies for the employed and job-seeking population.

Amid the general feeling that human resources management has developed significant vitality and responsiveness in the 1980s, this outlook group evaluates itself. Panel members offer their views on critical human resources issues and on the most important activities for managers in the future. These are quoted extensively as a kind of summing-up of the change that has been occurring. They contrast with what might have been said

Table 1: Forecasts for 1988 by The Conference Board's Human Resources Outlook Panel

	Median *(Percentage)*	*Range* *(Percentages)*
Overall increase in average hourly earnings, January, 1988 through December, 1988	2.8%	2.5 to 4.2%
First-year wage and benefit increases in major union contracts	2.5	1.5 to 3.2
Increase in labor costs per unit of output in manufacturing	0	-3.5 to 3.0
Rate of inflation (average increase in Consumer Price Index)	4.1	3.3 to 5.4
Unemployment average during 1988		
First quarter	6.0	5.8 to 6.9
Second quarter	6.1	5.7 to 7.5
Third quarter	6.2	5.7 to 7.8
Fourth quarter	6.3	5.4 to 8.0

AUDREY FREEDMAN
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in the 1970s, when concerns were focused on "administrative" issues. The quotations are certainly more inward-directed toward internal business problems or opportunities; they are much less a response to public policy intervention in the business environment.

Apart from government, the other external in business operations is, of course, the economic climate. It seems that human resources managers in the 1980s are becoming extremely effective conduits for signaling economic responsiveness on the part of business enterprises. This may be because they are now simply part of the business.

Where Are We in the Business Cycle?

A scant majority of the panel believes that business conditions and unemployment will remain relatively stable throughout 1988. Much of their reasoning is based on a sense that businesses have already discounted for the recession to come, or have become so efficient that further cutting will not occur even if the economy fails to grow. In other words, these members believe that the structural reforms are already adequate to the needs of an out-of-steam recovery, and they do not foresee that a sharp recession will occur requiring further cutbacks in 1988. This is the point of view the "stability" faction offers; their written responses focus on trade problems, stock market effects and fiscal policy, as well as their company economists' evaluations after the crash.

For example, Ben Dial, Executive Vice President-Human Resources, Pacific Telesis Group, postponed a business downturn in his forecast because he expects stock market events to cause appropriate federal action:

> "I believe there will be an economic downturn by 1989, although the recent stock market decline may cause actions that will avoid a downturn of any severity. It was an early warning, identifying serious imbalances in the economy such as the federal deficit, the declining value of the dollar, monetary policy and foreign trade imbalance.
>
> "We have currently had five full years of economic expansion fueled by business, consumer and government spending, and foreign investment. Government's budget has reached an imbalance between taxation and spending. Current budget levels cannot be maintained: There will be an increase in taxation or a decrease in spending. Either will have a negative effect on business and consumer spending, unless the Federal Reserve keeps credit easy and does not fight inflation fears with increased interest rates. A policy has recently been adopted of doing just that.
>
> "Because of the decline of the dollar and the market fall, there is a softening of foreign investment in the U.S. economy. If the dollar is allowed an orderly adjustment to market value, instead of erratic movement, the inflow of foreign capital may be regained. But if not, business and consumer spending is unlikely to be invigorated enough to have the momentum to replace the loss of government spending due to budget cuts, and the loss of foreign capital due to lack of confidence in the dollar.

BENTON W. DIAL
Executive Vice President
Human Resources
Pacific Telesis Group
San Francisco, California

> "The market decline was an early warning. Government is making difficult decisions and taking corrective actions on imbalances in the economy. Solutions other than recession or inflation and substantial increases in the deficit are being implemented. There are strengths in the economy that can be built upon. Exports, including manufactured goods, are increasing substantially, while domestic demand for American manufactured goods is also increasing. American labor and business are meeting the demands of competition through innovation and efficiency. Although I see an American economy that is dynamic and competitive, the severity of the numerous imbalances will still result in an economic downturn, but one of moderate duration."

Rex Adams, Vice President, Employee Relations, Mobil Oil Corporation, emphasizes the U.S. trade deficit and the loss of policy control caused by indebtedness:

> "At the moment, the underlying trends in U.S. trade are encouraging in volume and there are many encouraging signs of fundamental structural improvements in the competitiveness of the U.S. industrial manufacturing sector. How long it will take for this underlying trend to work down the trade

REX D. ADAMS
Vice President, Employee Relations
Mobil Oil Corporation
New York, New York

deficit, assuming a successful adjustment in the dollar exchange rate, is an open question, with the weakness of the agricultural export sector and an anticipated growth in the cost of oil imports to the U.S. economy.

"The primary issue here, of course, is the relation of the dollar exchange rate to the trade deficit. Most informed observers believe that the U.S. trade balance cannot be put right without a further depreciation of the dollar relative to the other main trading currencies on the order of 25 to 30 percent. Given the vast amount of private foreign capital presently parked in dollar assets and thus potentially exposed to exchange rate risk, it is not entirely clear how the necessary depreciation of the dollar can be managed without either (1) a significant disruption of capital markets, such as we have just witnessed; or (2) a run-up in U.S. interest rates, which would precipitate a recession."

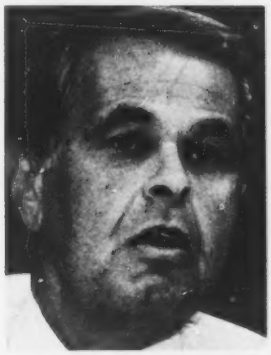
Austin Thorne, Secretary-Treasurer, Canadian Federation of Labour, agrees, but describes the policymaking in more provocative terms:

AUSTIN G. THORNE
Secretary-Treasurer
Canadian Federation of Labour
Ottawa, Ontario, Canada

"The negative U.S. investment flows, an increasing U.S. merchandise trade deficit and the U.S. federal budgetary deficit suggest that some acute policy questions (interest rates, further U.S. dollar devaluation, protectionism and fiscal policy) will need to be addressed.

"If decision makers use cyclical policies (higher interest rates and therefore a higher dollar) to deal with loss of competitiveness and structural decline rather than taking the competitiveness route (i.e., new products and process development), cyclical downturn could severely exacerbate the structural U.S. problems of 'a mature debtor' economy. It therefore appears that gradual currency decline is more likely than a recession, unless one is deliberately provoked for monetary policy reasons."

Even though current policy initiatives (other than deficit-cutting rhetoric) consist of attempting to lower interest rates as much as possible without discouraging foreign lenders, Irving Margol, Executive Vice President, Security Pacific National Bank, does not expect the effort to last.



IRVING MARGOL
Executive Vice President
Security Pacific National Bank
Los Angeles, California

"Rising interest rates will begin to slow aggregate economic growth in the second half of 1988, with real GNP rising less than 2 percent. We estimate, however, that higher rates accompanied by a flattening yield curve could result in a recession during 1989. We anticipate that this recession would be somewhat less severe than the last two recessions, reflecting the fact that peak inflation in 1989 will be significantly less than the double-digit inflation just prior to the last two recessions. This also suggests that peak interest rates will be significantly lower than the level of rates that preceded the 1981-1982 recession.

"Specifically, we anticipate that the recession would last three or four quarters, with real GNP remaining flat for 1989. The first recovery year would be 1990, with real GNP rising about 3 percent and inflation of about 4 percent. Healthy GNP growth in 1991-1992 is also predicted with somewhat higher inflation and interest rates."

Thus, even to the group that sees 1988 as a relatively flat year, the chances of delaying recession beyond next year appear dim. As Rex Adams explains:

"One would have to be oblivious to economic history to expect to get much beyond 1989 without a recessionary adjustment in the U.S. economy, and that adjustment is likely

to be troublesome. We're pretty much running the economy on a Keynesian full throttle right now with large public-sector deficits, low taxes, low interest rates, high employment levels, and stripped-down industrial capacity. That doesn't leave many fiscal or monetary levers to pull if the economy runs out of steam."

However, there are two optimists in the group. David Lewin, Professor of Business, Columbia University, expects continued expansion without any cautionary notes:

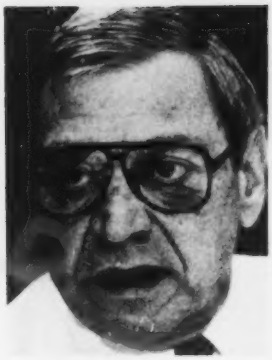
DAVID LEWIN
Professor of Business
Columbia University
New York, New York

"I do not visualize recession taking place shortly after the 1988 Presidential election. The economy is not nearly as subject to recession-inducing forces as it was in earlier eras. The healthy factors are increasing competition, fewer U.S. business sectors subject to regulation, antitrust prosecution so infrequent that it rarely forestalls any mergers and acquisitions, policies that permit almost any type of foreign investment in the U.S. economy, and appeals for 'protection' falling on deaf ears.

"In fact, the economy has expanded continously for five years even as major budget and trade deficits have been recorded (these deficits are not particularly large, however, when measured as percentages of GNP rather than in nominal terms). I believe that the U.S. economy is poised for *a major takeoff,* not poised for recession. Moreover, whichever political party prevails in the 1988 Presidential election, I do not envision any major changes in tax, regulatory, antitrust, trade or monetary policies. Hence, even if my forecast turns out to be off the mark, it will not be due to fundamental changes in the political environment."

The other optimistic view combines the elements of "later" with the mildness described by Irving Margol. This is a human resources-oriented version from Mitchell Fromstein, President and CEO, Manpower, Inc.:

"The next recession, in my opinion, still carries a 'later' label. Inflation is low. Production is high. Employment figures are still good. Companies are lean. The dollar is low, making exports quite attractive to global buyers. Consumer



MITCHELL S. FROMSTEIN
President & Chief Executive Officer
Manpower, Incorporated
Milwaukee, Wisconsin

spending is still strong. Interest rates are still low. I believe the Wall Street crash will, in fact, cool the only inflated element in the economy and actually help to prevent the recession people fear it will create.

"I suppose the question of the nature of the recession somewhat depends upon who wins the election. Business usually fears a Democratic administration but traditionally benefits from it economically. In that scenario, there will be a short period of 'blue funk' in which the market goes down and business pulls in its capital spending horns. If Republicans win, we will have six months of continued optimism and *then* a dip.

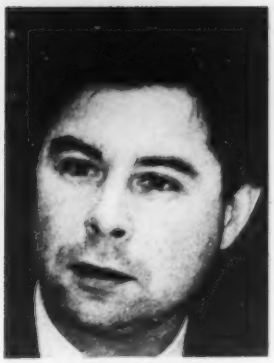
"In any event, I expect it to be mild. Reason—it is too universally expected to be a serious or protracted decline. The market has already discounted it. Business has been waiting for it. Much of the labor force has already experienced it in terms of low growth in earnings and shaky job security.

"I would expect less unemployment than is usually part of a recession. The shortage of entry-level workers will prevail and will cause employers to be cautious in laying off workers from already trimmed workforces. There is not much to 'reduce.' Consequently, it will cause some short-term discomfort, but not in any sense the traumatic dislocations of the twin 1980-1982 recessions.

"Construction will slow down. Major purchases may be delayed. Profits will slide from their record levels for one or two quarters, and an upturn will follow late in 1989 or early 1990."

Although he also expects a delay, Richard Belous, Senior Research Associate, The Conference Board, anticipates a much less mild and much more tenacious downturn:

"Unemployment will be drifting upwards by the end of 1988. By the time the 1988 Presidential election is held, conditions may not be bad enough to declare the country in an official recession. Nevertheless, the 'smoke and mirrors' expansion of the 1980s will have run out of steam. U.S. policymakers will then find themselves in a real bind. Given past federal government spending patterns, expansionary fiscal policy will be quite difficult to inject into the system.



RICHARD S. BELOUS
Senior Research Associate
Human Resources Program Group
The Conference Board
Washington, D.C.

Also, easy monetary policy will already be in force. Faster growth of the money supply would only make it more difficult to garner foreign funds—which have kept us going—and it would increase inflationary expectations.

"Thus, the next administration will face higher levels of unemployment, reduced capacity utilization, and many corporations in a real financial bind. Meanwhile, the fiscal policy gas tank will be empty and the monetary accelerator will already be pressed down to the floor. Policymakers will have a very tough time pulling the economy out of the next dive. Also, numerous corporations—with very high debt levels—will be in difficult situations. Simple monetary and fiscal policy adjustment will not be enough this time."

The negative view suggests that a recession is already beginning and will be difficult to foreshorten. Dan Mitchell, Director, Institute of Industrial Relations, University of California—Los Angeles, is one of two members who expect a substantial increase in the unemployment rate, lagging behind a business downturn this winter:

"Assume that the stock market does not substantially recover or even drops further. We then have a large, negative wealth effect depressing all manner of spending. In addition, we will begin to find that various firms, financial and nonfinancial, are in trouble because of actions they previously took on the assumption of a better stock market. It will cut both ways, of course. For example, pension funds with a lot of stocks will find themselves underfunded and needing infusion from employers. Those with a lot of bonds will find their portfolio values increasing as interest rates drop.

"Monetary policy can offset some of the negative effect on real output. So far it appears that the Fed has been dishing out money. It should continue to do so. There wasn't much of an inflation threat before; how can there be one now?

"However, monetary expansion acts with a lag and the stock market effect is more immediate, so it is difficult to avoid a recession through monetary means. All we can do is bail out those in financial distress and keep the downturn from snowballing.

"Moves to fix the deficit now, come at the wrong time. At this point it appears that all we are talking about is reallocating Gramm-Rudman cuts that would otherwise take place. If that's all that is involved, congressional action won't make any difference. If more is involved, the economy will be hurt (and the Fed should dump out still more money). In any case, the actual deficit will grow as the economy declines.

DANIEL J.B. MITCHELL
Director, Institute of Industrial Relations
University of California
Los Angeles, California

"The UCLA Forecast now sees a decline in economic activity starting this quarter and extending through the first half of 1988. Thereafter, some recovery begins. However, unemployment rises throughout the year, getting up towards 8 percent."

And so the discussion goes back and forth, with a prominent place given to the recent slimming-down of work forces. One panel member suggests that recession usually comes at a time when enterprises are bloated with excess labor, management layers, inventories, high wages and other signs of lax stewardship. But this time, he says, business is lean because competitive pressures in the 1980s have forced healthy changes. At this, another panelist interjects, "True, but the cutting and pruning will be faster and sharper." Whereupon the first responds, "Yes, the adjustment to recession will be rapid, and it will be a people adjustment."

Downsizing

All panel members believe that downsizing will continue in some industries; they uniformly use the term to mean shifting and redeploying human resources for maximum use and efficiency. This redeployment is a source of strength in the U.S. economy. Many members theorize that, because of previous downsizing, the whole economy may be better able to weather recessions. Ben Dial agrees:

"Downsizing is not always the real issue—often it is a question of redeployment. The overall number of employees may be about right, but most companies have to face the issue of having people with the right skills in the right places, of

movement of employees to those parts of the organization where their skills and contributions have the greatest value. Part of this deployment strategy includes the upgrading and retraining of employees who will remain employees because of their own desire or corporate employment security commitments.

"The results of downsizing have been pretty clear in our corporation. The ratio of productivity measures and financial earnings to the number of employees has improved steadily during our downsizing efforts. Some of this is due to technological change, but most of these improvements are the result of people working more efficiently and more productively and making a larger and more critical contribution to the business. The role of the individual employee is more critical than ever to the success of our business."

The view that downsizing creates major business efficiencies is held by several panelists. John Ellsworth, Vice President-Human Resources, Northern Telecom Ltd., states:

JOHN E. ELLSWORTH
Vice President-Human Resources
Northern Telecom Limited
Mississauga, Ontario, Canada

"Downsizing or 'right-sizing' is alive and well and will continue to draw interest and results in 1988. I find more ongoing interest to find ways to drop functions, roles, layers, niche-players—in short, to challenge the real 'value added,' not just at the annual budget/business planning but throughout the year.

"Right-sizing has evolved from the major downsizing efforts of the early 1980s to the point where the mindset is becoming more system-oriented but with no less fervor in the underlying belief that 'lean and mean' is the way to be. The systems orientation is leading decision makers to look at business flow and response time. Functions—individuals who are not obviously tied into the business flow—are in jeopardy whether business cycles are up or down. The fat is not going to go back into successful organizations."

Rex Adams concurs:

"The results of the 1980's downsizing include a more competitive manufacturing sector and a recognition of how real the global economy is. There has been a redistribution of the workforce from manufacturing to services and from large to smaller organizations.

"In the services sector downsizing will be more visible. The country's competitive edge is going to be dependent upon achieving productivity improvements in health care, education, financial services and government bureaucracies, all of which are manpower intensive."

Alan Ewalt, Senior Vice President, National Medical Enterprises, provides some current examples and then notes both the positive and negative outcomes:

ALAN R. EWALT
Senior Vice President
National Medical Enterprises
Los Angeles, California

"Downsizing has slowed down but I do not believe that it has stopped. I still expect that in mature industries the downsizing trend is both necessary and will continue. Those firms that have not experienced a major shake-out and that operate in highly competitive, mature environments will probably be forced to downsize or restructure. Of recent notice is Colgate-Palmolive, which derives most of its revenue from a mature toothpaste market. It announced a layoff of 600 middle managers, consolidation of plants, and a major shake-up to cut costs. It expects to wring additional profits out of its substantial market share by becoming more efficient rather than through market growth. Prior to the Colgate-Palmolive announcement, a major brokerage firm declared it was realigning and laying off a number of white collar employees because of operating inefficiencies.

"The downsizing/restructuring will hopefully produce a revitalization and preservation of U.S. industry in certain sectors. In others the revitalization is tainted by the number of workers who have been displaced and who have not yet been able to link up with substantial or meaningful employment."

David Lewin is interested in the work force that remains after downsizing. He raises the subtle point that the surviving employees may be better off in terms of salary. They may also experience increased job security because they are, presumably, working in a more viable enterprise. Lewin says:

"Downsizing does indeed appear to have slowed in general, although some of it continues in firms that have adopted multi-year reduction-in-force plans. This includes firms such as Ford, General Motors, AT&T, Pacific Telesis, NYNEX,

Becton Dickinson, Mobil, Du Pont, Corning, to name but a few. Note, further, that the top Fortune 1000 firms employ about 11 percent fewer people today than a decade ago. Employment growth has been concentrated in small- and medium-size companies, and I anticipate that many of these firms will be adding personnel in the next one to three years. They may well 'raid' existing larger firms to obtain such personnel, especially in light of the labor shortages that I predict will prevail during the remainder of this decade.

"The one remaining spur to additional downsizing is the merger and acquisition movement, which I believe will continue at a substantial pace. Mergers and acquisitions are almost always associated with reductions in force, so the downsizing phenomenon may slow but not disappear. Note further that it is worth paying particular attention to the 'survivors' of work force downsizing, who generally do more work and who may be considerably better paid after a downsizing than before it. In other words, I'm suggesting that downsizing involves work force but *not* work reductions and that some employees—those who survive—may have strong incentives to support such downsizing."

However, a decrease in morale among "survivors" of employment cuts is described by Rex Adams. And Irving Margol views the whole downsizing strategy as one of balancing the risks of excessive fixed payroll costs against employee disaffection and opposition to management. He does not mention union organizing because the frame of reference is white collar.

"Given the number of employees already let go, actual downsizing has slowed; most companies have taken their major hits. Downsizing as a trend, however, will continue; it fits the current short-term orientation of American management.

"Internally, the results are clear. In addition to an eventual decrease in compensation expense, a resultant decrease in morale and commitment and a short-term decrease in productivity are evident from those left to carry on. Management is clearly risking that these short-term costs will be outweighed by the long-term gains in productivity and efficiency.

"With those let go, two effects are apparent. First, greater emphasis is focused on the possibility of white-collar employment-at-will litigation. Second, downsizing fosters a large number of entrepreneurs and the creation of an 'underground' economy of independent agents/consultants.

"Clearly the balance of obligations between the employer and the employee has been spotlighted by management's downsizing, short-term actions."

Looking only at manufacturing, Dan Mitchell sees a positive effect:

"If one thinks manufacturing is the center of downsizing, it is interesting to note the gap between productivity performance there and productivity performance elsewhere in the economy. During 1979-1986, output per hour rose at a 3.2 percent annual rate in manufacturing and 0.9 percent for the private nonfarm economy as a whole. Manufacturing productivity looked good; everyplace else it looked bad. Presumably, manufacturers were closing their least productive facilities during the competitive squeeze of the 1980s, thus raising the average. (It wasn't all robots!)"

Austin Thorne argues with this and says that it is mostly automation that cuts factory labor requirements:

"Downsizing has not stopped and certainly not in terms of employment. CAD/CAM, robotics and fully automated factories of the future can be expected to generate further employment losses."

Mitchell Fromstein relates the downsizing subject to the October stock market crash. He reiterates that U.S. business is lean and fit to weather a downturn, but he expects some immediate cutbacks in financial services—the first industry to be hit.

"I believe that downsizing has slowed down as a macrotrend, i.e., the broad-based trend of business trimming staff has run its course. At the same time, the downsizing or restructuring technique has now become an accepted part of management's set of tools to deal with adverse or unique conditions and therefore it continues on a selective basis. Most major U.S. companies have utilized the process at some time over the past five years and currently stand in a trimmed-down condition.

"Sectors such as banking, brokerage and financial services, which will be hard hit by the market crash, can be expected to 'downsize' quickly to meet cost constraints and operating losses. In former economic periods this would be done slowly, quietly and with a modicum of embarrassment. Today it can be done quickly, publicly and without loss of image or pressure on the corporate conscience. We are beginning to see it even now.

"The paradox, however, is that the paperwork has ballooned in these same sectors, requiring *more* staff."

More Employment Security or More Fluidity?

The speed with which the economy and its business firms can adapt to new circumstances is affected by its labor "flexibility." Can workers be reemployed or reassigned where they have been underproducing because of outmoded equipment, inappropriate industry allocation of resources, or changed markets?

Where this labor mobility is inhibited, the economy underperforms and its businesses are not competitive. On the other hand, constant and rapid redeployment of human resources can undermine individual incentives to invest in training and employer incentives to develop workers and managers. Moreover, such advanced fluidity can leave the society and in-

dividual insecure, without attachment or loyalty. An even more serious problem can occur: If it develops that one part of the workforce has some security *at the expense of other workers,* the inequity can become unacceptable.

Our panel discussed this apparent trend toward more fluidity and the social pressure for more security. Several members are concerned that management's need for "quality" work forces must be recognized, even by cost-cutters. Some observe that public acceptance of job insecurity will not last. Court challenges to "employment-at-will" and legislation to regulate plant closings are examples of a backlash. Irving Margol observes:

"It is obvious that job security no longer comes from affiliation with an organization. No one is offering lifetime employment; even the traditionally stable organizations like IBM and Hewlett-Packard are beginning to change their practices.

"I do not observe any contingent employment arrangements being made across the board either. However, contingent employment arrangements will grow in prevalence with top executives or key employees, particularly technically oriented employees.

"Job security must be replaced by 'competence security.' That is, those individuals who maintain a high competence level in their profession will gain a greater sense of security than organizations can provide."

John Ellsworth supports this view:

"I agree with you on all counts: fluidity, movement, non-security, contingent employment are all growing. Historical employment relationships and entitlement mentalities are gone. Terms of the 'new employment relationship' are being written and rewritten in these very months in many North American corporations.

"At the planning stage, most human resources plans now incorporate the surge tank concept of contingent workers clustered around a smaller core work force of full-time employees.

"At the selection point, increasing attention is being paid to criteria like 'capacity to learn,' 'adaptability,' and 'flexibility' as hurdles for entry into regular full-time positions.

"There is also an increasing willingness to cater to the preferences of the individual for part-time or contract employment that will be mutually beneficial. There is more interest in hiring workers with varied experience. An individual who has had significant experience with three or four major employers over 15 or 20 years is much more attractive than the individual with 15 or 20 years with one firm. As this becomes more widely understood, individuals will direct more of their attention to managing their careers across a span of employers.

"More attention will be paid to construct equitable benefit packages for full-time/part-time/contract employees. As pensions move from 'reward for long service' to 'deferred compensation,' strides will be made in designing comprehensive prorated benefit plans for contingent workers.

"On the training/development frontier, interest will increase in leasing or contracting fully-trained employees who can come in and be productive from day one. The increasing demands for specific skill/knowledge levels combined with the uncertainties of the marketplace and the resultant uncertainty of labor requirements will make the lease option more viable.

"Job security sloganeering is really a disguised appeal for richer early retirement and more training. I also believe that much of the job security noise is really based on genuine pleas for more open communication on the business health of the enterprise and more information on which to better base the self management of one's working life."

Alan Ewalt, Ben Dial and Dan Mitchell see two contradictory trends developing. Ewalt says:

"Candidly, I think the issue is moving in both directions at the same time. There is one sector of the work force digging in its heels and concentrating on security. This is particularly apparent in the automobile industry where increased security was emphasized over other economic issues in the recent UAW contract negotiations. While employment shifts toward smaller and non-union employers, i.e., under 500 employees, there are fewer workers covered by security arrangements. These newer organizations generally want to be 'lean and flexible,' so they are conditioning their labor force with the values of fluidity and movement.

"One way to examine the issue is graphically. If one were to view the labor force as a pyramid with the base being firmly anchored in jobs with security and stability and the higher up on the pyramid one goes the greater the fluidity required/expected, then the point at which the fluidity becomes more intense is now lower on the pyramid than in years past. One should also visualize that, as the 'fluidity' mark moves lower on the pyramid, it creates forces that drive the base of the pyramid (the high-security group) to sink roots deeper and deeper to anchor its position. The more security is threatened, the more certain workers grasp to preserve it. Clearly though, there is a momentum down the pyramid in today's marketplace toward greater fluidity."

Ben Dial also contrasts the traditional industries with less secure service-producing industries and jobs:

"The contradictory 'hints' indicate an intensified bifurcation of employment security trends. As the restructuring of corporate America continues, job security issues among the nation's largest employers become more public and more vocal than they have been. For most of our past, job or at least employment security has been an unquestioned assumption of traditional corporate life.

"In segments of the labor market this has not been the case. Many service-related industries have traditionally seen great turnover and a lack of job security with a particular

employer, although there has often been a great sense of employment security within the particular industry. Many sales people and computer programmers also have this more flexible notion of employment security.

"The 'contingent' workforce is growing. Many of the people in this temporary labor market are not there by choice. These workers, along with those who want to avoid ending up in this labor market, will continue to call for greater job and employment security from U.S. businesses.

"In the more heavily unionized and traditionally more secure industries, we are now seeing employers attempting to move toward more flexible productivity- and earnings-related employment security agreements. These industries, which have often had specific job security agreements with their workers, are the ones meeting the most resistance to change. The recent agreements between the UAW and Ford and General Motors include employment security clauses that meet at least some of the needs of both management and labor. I think we will see a trend toward employment security agreements designed to meet new economic realities at the same time as we see the continued growth of the 'non-secure' job market."

Dan Mitchell thinks that the growth of contingent employment or flexible employment relationships is due to an oversupply of labor or "slack labor markets," which force employees to take less desirable job slots.

"It is hard to measure worker preferences on these issues, but let me use one measure: voluntary part-time.

"Consider the following data:

	Annual Rate of Increase	
	1973-1979	*1979-1986*
Voluntary part-time employment	3.0%	1.2%
Full-time employment	2.4	1.5

"During the 1973-1979 period (cyclical peak to cyclical peak), voluntary part-time employment did grow faster than full-time. Since the part-time was voluntary, we can assume it reflected employee preferences. So preferences apparently shifted towards more flexible working arrangements. But during 1979-1986, we see no sign of such a preference shift. Voluntary part-time grows slower than full-time. In short, the preferences were not there in the 1980s, but the labor market result was. So it looks as if employees were getting what they didn't want. When labor markets are soft, there will be more people available to fill irregular jobs. When they are tight, the irregular pool will dry up."

Mitchell's view is in direct contrast to that of David Lewin. Lewin expects labor market "tightness"—i.e., labor shortages—and says that this will give employees the power to control hours and job commitment. As a result, there will be higher labor mobility and "marked fluidity in the labor market."

"First, the proportion of U.S. industries classified as competitive (rather than as monopolies or oligopolies) continues to rise and is now at about 80 to 82 percent. Both in manufacturing and service industries, productivity has increased substantially. These developments translate into lower product prices, which in turn spur increases in the demand for products and services—and in the derived demand for labor. Stated more simply, I expect to see even more job creation in the United States in 1988-1990 than was experienced in recent years when record high levels of jobs were created.

"Second, the U.S. economy is on the verge of perhaps the most severe and sustained period of labor shortages that has been experienced in this century. This forecast is based on three factors that affect labor supply, namely, demographics, immigration, and screening in employee selection; each of these is briefly discussed below.

"The major demographic fact about the U.S. population and work force is that of 'aging.' The average age of the population is presently about 32 years (compared to 25 years in 1960) and will rise to about 36 years by the end of the century. The live birth rate per 1,000 fertile women continues to be less than 15.0 annually (compared to between 23.0 and 24.0 annually in the 1960s), and family size continues to decline. To some observors, this implies shortages of labor only for entry- and senior-level jobs, but for other reasons to be outlined below I believe that the coming labor shortages will also be evident in middle-level jobs. Note further that the average age of retirement is declining slightly (from roughly 63 to roughly 62, according to the Social Security Administration), as is the labor force participation rate for 55- to 64-year-old men.

"Concerning immigration, the major development, of course, is the new federal legislation pertaining to the 'documentation' of immigrant workers with employers being required to carry out the enforcement function. While it is possible for reasonable people to disagree about the magnitude of effects on the incidence of immigration and the supply of immigrant workers, it is impossible to disagree that the legislation will restrict the labor supply relative to its level in recent years.

"The combination of drug testing, AIDS testing and polygraph testing, all of which are increasing dramatically, can only reduce labor supplies to firms and industries relative to what they otherwise would have been. Should such screening be substantially expanded to present employees rather than being confined to job applicants, the labor supply effects will be even more pronounced.

"When all of this is added up, it strongly suggests that the 'issue' of job security will dissipate during the 1988-1990 period. Certain claims to and negotiations over job security will be evident, as they are at present in the automobile industry. However, the much stronger trend will be toward labor mobility, job changing (hopping), and a *marked fluidity in the labor market.* Power in the employment relationship, which has largely resided with the employer in the

1982-1987 period, will increasingly rest with the employee in the 1988-1990 period."

Richard Belous explains that the demands for job security arise in a more competitive labor market—they are calls for protection. He thinks that part of the reason is that the U.S. private welfare system is linked to stable one-employer relationships:

"The fact that many union officials and members of Congress have placed job security high on their agendas is a direct consequence of increased fluidity. If flexibility had not changed then there would be no need for union representatives and many lawmakers to get hot under the collar about this situation.

"If one considers contingent workers to be part-timers, temporary workers, business services and the self-employed, then more than half of the jobs created in the 1980s have been contingent-worker jobs which are much more fluid than traditional core jobs in a company. Between 1980 and 1986, temporary employment has increased by 75 percent; part-timers by 20 percent; and business services by 45 percent. Meanwhile, in the same time period, the total U.S. labor force increased by 10 percent. Beyond fluidity related to contingent-worker growth, there have also been significant flexibility increases in terms of work-rule reductions and gain-share plans within many companies.

"This type of labor market fluidity should be encouraged since it helps North American companies to better compete in world markets. But there are potential problems to increased fluidity. While labor markets have become more flexible, the vast system of private and social welfare—including pensions, health insurance, unemployment insurance, and so forth—has not become more flexible. For example, most private pensions are portable only to a very limited extent. Increased labor market flexibility should be matched by increased flexibility in public and private social welfare systems. If pensions and other benefits were more portable, then more workers would welcome increased labor market flexibility.

"If labor markets become more flexible and private and public social welfare systems remain rigid, there could be serious problems down the road."

Mitchell Fromstein points out that a core work force will have more security the more the employer uses contingent work arrangements:

"This question has been addressed by the panel for three consecutive years. Each year the issue is a more prominent one. It seems to me that the answer has been unfolding steadily and is now quite clear. Business, in order to meet the new standards of performance in a global society, has adopted new approaches to work force costs and management. One can call it flexibility, fluidity, contingency or use any other term—the essence of it is the perceived need to avoid a commitment to the full work force needed at any given time. It is the use of part-timers, the use of temporary workers, the use of outside services and the subcontracting of various functions.

"The onset of discussions of job security is a *result* of the trend rather than a replacement for it. It arises mainly in the collective bargaining process. The facts of life, however, indicate that job security for one person will result in contingent employment for another. The core work forces are getting security assurances and the supplemental workforces are being hired or used on an 'as-needed' basis. The specifics in support of this trend are numerous and clear:

"The Bureau of Labor Statistics' monthly count of workers supplied by temporary help services recorded 1,000,000 workers in August, 1987. This compared to 818,000 in August of 1986 and 738,000 in August of 1985.

"An increasing percentage of the total work force is now employed in part-time and temporary work.

"The number of working mothers and two-income families has trebled over the past three years. This has provided employers with a work force that views work experience as a short-term commitment rather than a career opportunity.

"The 'labor' input of productivity measurement (permanent employees) has been replaced to some extent by an element called 'purchased services.' These are essentially one or more forms of optional worker resources. Labor input since 1973 has declined by 1 percent, while purchased services have increased by 2.6 percent compounded annually (BLS data).

"I believe that job security for some can arise from the contingent status of others and serve the interests and desires of both as well as the needs of private enterprise."

Wage Trends

The panel expects a modest rise in average hourly earnings of just under 3 percent in 1988 (see Table 1). With an expected inflation rate of over 4 percent, this means a very slight decline in "real" wages next year. Compensation plans surveyed by consultants show 1988 plans about level with 1987; however, most of the consultants' surveys took place before the stock market drop (see box).

Incentive systems are expected to increase in popularity because they create added flexibility for the company. Alan Ewalt states:

"Incentive compensation is experiencing a significant growth as companies continue to focus on performance and pay-for-performance. Incentives and bonuses provide a form of contingent compensation which is payable if results are there, but which does not create an expense for the company if results are unsatisfactory. The American worker, particularly the white-collar worker, sees a greater and greater portion of income tied to bonuses. Even non-exempts and blue-collar employees are experiencing a growth in 'gainsharing' as a means to enhance identification with the firm and increase productivity."

A Survey of Surveys: Salary Plans

Organization	Level of Employee	1987 Salary Increase	1988 Planned Salary Increase
American Compensation Association	Executive	5.5%	5.4%
	Exempt Salaried	5.2	5.2
	Nonexempt Salaried	5.0	5.0
The Conference Board	Executive	5.5	5.0
	Exempt Salaried	5.0	5.0
	Nonexempt Salaried	5.0	5.0
ECS, Inc. a Subsidiary of The Wyatt Company	Executive	5.6	5.4
	Exempt Salaried	5.1	5.0
	Nonexempt Salaried	4.9	4.9
Handy Associates	Exempt Salaried	5.1	5.2
Hay Management Consultants	Executive	5.5	5.4
	Exempt Salaried	5.2	5.2
	Nonexempt Salaried	5.0	5.0
Hewitt Associates	Executive	5.5	5.3
	Exempt Salaried	4.8	4.9
	Nonexempt Salaried	4.6	4.7
William M. Mercer-Meidinger-Hansen, Inc.	Executive	5.8	5.6
	Exempt Salaried	5.4	5.2
	Nonexempt Salaried	5.2	5.0
Sibson & Company, Inc.	Executive	6.0	5.5
	Exempt Salaried	5.4	5.2
	Nonexempt Salaried	5.4	5.2
Towers, Perrin, Forster & Crosby	Executive	5.0	5.2
	Exempt Salaried	4.9	4.9
	Nonexempt Salaried	4.7	4.7

For the fifth year, most of these surveys show a lower estimated increase for executives than the prior year's actual increase. In contrast, for exempt and nonexempt salaried employees the 1987 actual increases are virtually identical to those projected for 1988.* This represents a leveling off of the generally downward trend reported here in the last four years.

The rather conservative estimates probably reflect management's continued determination to control fixed compensation costs in a period of economic uncertainty. Not reflected in these estimates, but no doubt a factor contributing to their comparative modesty, is the increased use of non-salary pay for performance. These payments reward employee performance without increasing base salaries.

Charles A. Peck
Senior Research Associate
The Conference Board

Data compiled by:
Elizabeth R. Arreglado
Research Analyst

*The actual change in pay over the previous year's ending payroll is usually less than the anticipated average increase.

John Ellsworth makes an important cautionary point:

"The downside risks of these approaches will be the inability to reward employees in business downturns when their individual contribution may be needed the most."

Irving Margol observes a growing practice that will spread throughout the higher-paid workforce, and perhaps beyond:

"With compensation and operating expenses growing at a faster rate than income, boards of directors are demanding to know why pay for professionals and executives cannot be linked to objective measurements of corporate success.

"Therefore, the compensation opportunity available will be modeled on a competitive base with merit increases tied to some other index, and with total compensation geared to bonuses based on performance. Rewards will, in turn, be based on individual, team, or organizational performance, or some combination thereof.

"This model has the benefits of rewarding directly for performance, sending a loud and strong message about the importance of performance, and recognizing deserving employees for extraordinary performance. At the same time, lump sums and bonuses afford management more direct budgetary control through immediate comparison to quarter-by-quarter results."

Rex Adams agrees about the incentive trend for executives; is guarded about opportunities to use incentives for lower-level employees; and expects no acceptance from unions:

"There is a strong trend in industry to place more executive compensation 'at risk' and I believe this trend will strengthen in the years ahead. This trend complements the U.S. drive to restore economic competitiveness and will strengthen the pay-for-performance characteristics of executive compensation plans.

"We will continue to move cautiously with other gainsharing or profit-sharing concepts in the general work force. There are a number of pilot tests operating in refineries and chemical plants that appear promising. However, there will need to be several years of evaluation to determine if measurement criteria are aggressive yet realistic, and whether the plans are actually accomplishing their objectives.

"I believe unions will be slow to agree to placing any substantive amounts of compensation 'at risk'—but they will be receptive to rewards for increased productivity."

David Lewin moves the discussion toward a distinction between incentive bonuses and one-time, "lump-sum" payments.

"I believe that the trend toward lump-sum and bonus payments will continue to grow in 1988. Such payments are consistent with the recently observed trends toward labor cost-containment and pay for output or performance. The lump-sum payment keeps the base wage or salary stable and this slows the future growth of pay and benefits. The bonus payment makes a portion of compensation contingent on unit or organizational performance.

"Conceptually, lump-sum and bonus payments are very different. The former substitutes for an increase in the base wage or salary, is typically paid at the beginning of a relevant accounting period, and is 'known' both at the beginning and the end of the period. In fact, once paid the lump-sum is a fixed cost of operations. In contrast, the bonus payment is not so clearly a substitute for a wage or salary increase, occurs after the fact, and is 'known' only after the total unit or organization's performance has been measured. It is a 'variable' cost in the purest sense of the term. Further, both types of payments can occur only in firms that do not have major cash flow problems. Nevertheless, I expect that the incidence of both types of payments will rise in 1988."

Ben Dial's comments shift the subject into the union contract territory where it is examined by Dan Mitchell. Dial says:

"Lump-sum payments were increasingly introduced following the recession of 1982 when employers' cost concerns mounted and inflationary concerns diminished. Because of the concern about foreign competition and job security, union leaders were more 'willing' to bargain lump-sum increases for their members in exchange for continued employment (although no guarantees were given). Because the initial tension caused by lump sums has gradually dissipated and employees have accepted this form of compensation, unions will probably not have much trouble gaining member approval of lump sum contract provisions.

"There has been a significant increase in the number of compensation methods that focus on performance at all levels of the corporation—individual, small group, large group, etc. Lump-sum payments provide the means for rewarding performance without increasing base compensation. Thus, supplemental payments related to base pay are not increased, yet specific performance accomplishments can still be recognized and rewarded.

"Inflation is expected to increase over the next 12 to 18 months. Therefore, employers will be more likely to want to make one-time payments that do not incorporate inflation increases into an individual's future wage base, and thus a company's overall labor costs."

Dan Mitchell's long-standing interest in gainsharing produces the deepest analysis of how a lump-sum wage practice might evolve into a profit-sharing arrangement. First, he gives the reasons for the growth of lump-sum union wage increases:

"There are two motivations behind lump sums. The first is paying less and the second is contingent payments. An employer in a unionized situation—where lump sums appear to be concentrated—saves money by signing a three-year contract with annual 3 percent lump sums as opposed to annual

3 percent wage increases. The former is equivalent to one 3 percent increase at the beginning of the contract and no increase thereafter; the latter amounts to 9 percent by the contract's end. Depending on the contract's language, the lump sum may not be reflected in certain fringes such as pensions; the wage rate increase is more likely to trigger fringe roll-ups.

"Viewed as money-savers, lump sums are part of the wage concession movement and the weakened bargaining posture of unions. Concessions as I measure them—contracts with zero or less basic wage adjustments—are still rolling along with surprising momentum this year. During the first half of 1987, BNA reports 37 percent of its contract negotiation sample had first-year wage freezes or cuts. About one-fifth of the contracts had lump sums. With lump sums factored in, the percentage drops to 21 percent. First year wage adjustments were 2 percent (3 percent with lump sums factored in). Yet CPI inflation during this period was around 5 percent.

"The BLS report for major contracts is similar. One-third of the employees under major contracts had wage freezes and cuts in the first year. Lump sums covered 22 percent of workers under major settlements. BLS also reports that union wage increases measured by the Employment Cost Index were still being outpaced by non-union.

"So, unions continued showing signs of bargaining weakness. As long as that tendency continues, lump sums engineered for money-saving reasons by employers will go on being negotiated. Although the popular press is talking about a union 'turn around,' it is hard to see signs of it in bargaining outcomes. Membership losses may well turn out to have halted in 1987. Unions can claim some victories in the Coors settlement, the re-unionization of air traffic controllers, etc. But all of that has yet to be translated into wages.

"An article in the *American Economic Review* (September, 1986) provides the results of a telephone survey in which respondents were asked questions about business situations and asked to rate the behavior as fair or unfair. Some of the questions involved pay reductions. One posed a case of a company in economic difficulty that cut pay by some amount, say 5 percent. Another question cited identical company circumstances, but indicated that the company had always paid a 5 percent bonus in the past, then eliminated it during hard times. Respondents generally rated the pay cut as unfair, but the bonus elimination as fair. They were monetarily identical: in both cases workers' take-home pay fell 5 percent.

"Why was there a discrepancy in the public reaction to seemingly identical situations? Because the word 'bonus' implies something different from 'wages.' Bonuses are not perceived as guaranteed.

"Lump sums have the potential of becoming an ersatz profit-sharing plan along the lines of the Japanese bonus system. A system could evolve—or perhaps is evolving—in which negotiations in good times produce bigger lump sums; negotiations in bad times produce smaller lump sums (or

Table 2: Selected Major Contract Expirations in 1988 by Industry, Company, and Union

Month of Contract Expiration	*Industry*	*Company*	*Union*
January	Chemical	American Cyanamid	Chemical Workers
	Oil	7 Oil Companies	Oil Workers
	Coal	Bituminous Coal Operators Association	Mine Workers
	Utility	Northern States Power	Electrical Workers
	Transportation	Sugar Companies Negotiating Committee	Longshoremen and Warehousemen
	Communication	U.S. Postal Service	Rural Letter Carriers
February	Entertainment	Alliance of Motion Pictures and Television Producers	Writers Guild
	Retail	Kroger Stop and Shop Supermarkets	Food and Commercial Workers
	Transportation	Marine Towing and Transporation Employers' Association (NY)	Longshoremen's Association
March	Transportation	National Master Freight Agreement	Teamsters
	Manufacturing	Budd	Auto Workers
April	Rubber	4 Rubber Firms	Rubber Workers
	Housing	New York Realty Advisory Board	Service Employees
	Utility	Southern California	Chemical Workers; Utility Workers
		Virginia Electric	Electrical Workers
	Airlines	United Airlines	Airline Pilots

Table 2: (Continued)

Month of Contract Expiration	*Industry*	*Company*	*Union*
May	Apparel	Major Apparel Firms	Ladies Garment Workers
	Tobacco	American Tobacco	Bakery, Confectionary and Tobacco Workers
	Transportation	Industrial Employers and Distributors Association (Calif.)	Longshoremen and Warehousemen; Teamsters
		National Master Automobile Transporters Agreement	Teamsters
	Electronics	Magnavox	Allied Industrial Workers
	Airlines	Northwest Airlines	Machinists
	Textiles	J.P. Stevens	Clothing and Textile Workers
June	Construction	Associated General Contractors (California)	Laborers
	Forest Products	Boise-Cascade	Western Council of Lumber Production
		Champion International Wausau Paper Mills	Paperworkers
		Weyerhaeuser	Woodworkers
	Railroads	Class I Railroads; Conrail	Locomotive Engineers; Railway Clerks; Transportation Union
	Electronics	General Electric	Electronic Workers; Electrical Workers
July	Hospitals	Affiliated Hospitals of San Francisco	California Nurses Association
	Airlines	Eastern Airlines	Airline Pilots
August	Entertainment	Alliance of Motion Pictures and Television Producers	Theatrical Stage Employees
	Airlines	USAir	Airline Pilots; Flight Attendants
	Electronics	Westinghouse	Electronic Workers; Electrical Workers; Machinists; Federation of Westinghouse Salaried Unions
September	Auto	Chrysler	Auto Workers
	Airlines	Pan American	Independent Union of Flight Attendants
	Electronics	Sperry	Electronic Workers
October	Entertainment	Alliance of Motion Picture and Television Producers	Office and Professional Employees
		Walt Disney	Service Trades Council
	Equipment	Caterpillar; Deere	Auto Workers
	Shipbuilding	Norfolk Shipbuilding	Boilermakers
November	Auto Parts	Champion Spark Plug Autolite	Auto Workers
	Utility	Florida Power and Light	Electrical
	Steel	McLouth Steel	Steelworkers
	Aircraft	United Technologies	Machinists
December	Communications	Associated Press	Newspaper Guild
	Airlines	Eastern Airlines	Transport Workers
		Northwest Airlines	Railway Clerks
	Utility	Public Service of Colorado	Electrical Workers

Source: Bureau of National Affairs and Bureau of Labor Statistics. Prepared by Richard S. Belous.

maybe no lump sum). There are reasons why both sides—union and management—could find lump sums to be in their mutual interest.

"Some of the upcoming contracts in 1988 include rubber, petroleum, coal, railroads, trucking and electrical equipment (see Table 2). There are already lump-sum provisions in the current contracts of electrical equipment, petroleum and railroads. Is the economic outlook so certain for the industries negotiating in 1988 that some lump sum element might not be advisable? Rubber, for example, is partly dependent on the volatile auto industry for original equipment sales. Coal depends on energy prices. Trucking is now in a deregulated environment."

Regarding the union bargains of 1988, Richard Belous, who devised Table 2, expects the lump sums to be negotiated for second and third years and a wage rate increase to be placed at the inception of the contract:

"Lump-sum payments will remain a key compensation tool in 1988. They will be used as a means of restraining long-run labor costs. However, the new switch will be that labor contracts will edge more towards *front loading*. Prior to the 1980s, most labor contracts were front-loaded—the major benefits and goodies came in the first year or so of the agreement. But in the 1980s, many labor contracts become back-loaded—any benefits and goodies came in the last year of the agreement.

"The new contracts in the auto industry contained wage increases and lump-sum payments. But the wage hike was front-loaded and the lump-sum payments were back-loaded. This represented a shift. Thus, lump-sum payments will remain, but I would expect that more of them will be seen in the second and third year of agreements—and more moderate wage increases will come in the first year of agreements."

Government Actions

Minimum Wage Increases

The panel disagrees about the chances of an increase in the minimum wage. However, the issue does not seem to be of crucial importance to business—or at least large business. Several panel members note that the effective minimum is now higher than the legislated minimum because of strong labor demand and relative shortages. Immigration restriction has also reduced supplies of low-wage workers and raised wages in parts of the country accustomed to huge immigrant flows. Irving Margol begins:

"An increase in the minimum wage will come up either as a pre-campaign issue or in the early part of the next presidential term. I expect that the minimum wage will increase in California, as a precursor to being increased nationally.

"An increase does not affect Security Pacific Corporation because our hourly wage for non-exempt employees is currently above the minimum. However, an increase would affect our hiring of high school students and students that we employ for the summer, as well as our programs for disadvantaged individuals (who are currently paid close to the minimum wage). An increase in the minimum wage would drive up the costs of offering such specialized employment programs.

"Although the minimum wage can't be keyed to inflation, it must be benched on what is politically feasible and likely to be passed. I predict that the minimum wage will increase to somewhere between $4.00-$4.25."

Dan Mitchell comments that employers might "substitute" adult women for teenagers because "changing the minimum wage redistributes income, as employers shift their demand for labor from one group to another."

Richard Belous expects that strong labor backing will result in an increase this year:

"The massive federal budget deficit has blocked the possibility of establishing new labor-related government spending programs in almost all areas. However, Congress is under strong pressure to establish a track record in the labor area. A good portion of this pressure comes from labor unions. Unable to reverse membership declines, many union leaders want to show that the labor movement is alive and kicking via a political agenda.

"The minimum wage is high up on the union political agenda for several reasons. First, union officials do not like to be called a special interest. Part of the labor movement ethos is that it represents more than just the interests of its members, most of whom are paid well above the minimum wage. Fighting for the minimum wage is a major way to show that organized labor represents the general interests of all working people.

"Second, unions hope to increase membership within the ranks of service workers, who are often paid far less than steel workers and auto workers. Almost one-quarter of U.S. manufacturing workers are still union members. However, only 7 percent of wholesale and retail trade workers are part of the labor movement; less than 3 percent of workers in finance, insurance, and real estate industries pay union dues; and fewer than 7 percent of service workers have joined unions.

"Yet experience shows that it is very difficult to unionize workers who have very low pay. It is somewhat easier—other things being equal—to unionize workers who are not at the bottom of the pay ladder. The minimum wage is one way to move up the lowest levels on the pay ladder, and it may create the conditions that could help unions to win more elections in the service sector of the economy. If a higher minimum wage decreases labor turnover in some parts of the service economy then more workers might be willing to expend the human capital to win a union election. This is

not to say that a higher minimum wage will increase unionization, but I believe many union leaders think that it will improve their chances in a growing part of our economy.

"Not only will a higher minimum wage be the top item on the labor agenda, but the entire issue of the working poor will once again become fashionable. Despite lower unemployment rates, the conditions of the working poor in America will be a very sore point. Indications are that the major portion of the poverty population is already working. As a nation we have tended to think of people either as working *or* being on welfare. The actual data show more of a picture in which individuals try to mix work *and* welfare. It is very easy to dream up textbook programs that do a better job of this mixing than does the minimum wage. But the reality of the current political economy is that these other plans do not have enough steam to make them into law. Thus, despite all of its faults, the minimum wage will remain the key government-directed effort to help the working poor in this country."

David Lewin disagrees with Belous on the level of effort that the AFL-CIO will expend on a minimum wage campaign.

"The AFL-CIO will devote its activities largely to the presidential and congressional elections and will not dissipate its resources on legislative matters. Prevailing sentiment against federally inspired upward wage pressure is still strong, and, during a presidential election year, the Congress is unlikely to involve itself deeply with the minimum wage issue. I say this despite the fact that the federally mandated minimum wage will fall to perhaps 35 percent of the average hourly manufacturing wage during 1988.

"The prospect for an increase in 1989 in the minimum wage is greater, but even then the bulk of attention will be paid to a tiered minimum that provides a lower wage for teenagers. I expect this to be a highly debated issue despite the fact that actual entry-level wage rates, especially for teenagers, are already rising rapidly."

Rex Adams covers several aspects of current proposals:

"At least two schools of thought exist regarding the total labor union agenda. One espouses the 'domino theory' to the effect that, if labor gets one of its bills enacted, the others will be enacted. The other holds that Congress, believing that labor is 'due,' will pass one or two items of its agenda and then will think it has done enough. We in Mobil hold to the latter view. With so much of the U.S. work force nonunion and with general concern over spending and particularly with special interest 'give-away' legislation, Senators and Representatives will not want to be viewed as doing too much for labor.

"Interestingly, labor currently has the minimum wage increase on a back burner as it pushes for other items on its agenda. Thus, an increase is more likely to be a spring 1988 item. Once done, it won't be an issue in the early years of the next administration.

"As to the employment effects, we are not concerned in oil. We could, however, see an impact on our merchandise retailing operations. Our current hiring rates in retail around the country range from $3.85 to $4.00 per hour. At issue, if the minimum wage got into that range, would be summer hires, particularly minority summer hires. As payroll costs went up, we would have to offset them by cutting help (with the resultant decrease in customer service) or by raising prices, neither of which we would care to do.

"The business community, including Mobil, opposes indexing as strongly as any aspect of the current legislative proposals. The minimum wage has been held down over the decades by requiring the discipline of Congress having to enact increases. That practice should be maintained.

"The outgoing Secretary of Labor has indicated that the Administration is willing to negotiate. I believe it will be very interested, in addition to no-indexing, in the creation of a real 'youth differential'—probably by holding the minimum wage for youth at or near $3.35. For reasons pointed out above, we would support such a differential."

Austin Thorne provides a nontraditional union point of view, emphasizing labor costs and competitiveness. He begins with a comment about the minimum wage as a poverty-reducing measure:

"Traditionally, minimum wage policy has been (1) conceptually based on the earning capacity of an individual, (2) the lowest socially acceptable wage, (3) the lynchpin between economic policy and social policy.

"Welfare programs have been based on need (e.g., family size) and receive different tax treatment. The fundamental conceptual design conflicts between welfare 'need' and minimum wage 'capability to earn' have given rise to the 'poverty trap.' That is, an unskilled person with a large family can collect larger benefits through the welfare system than by working. Additional penalties or disincentives are incurred through different tax back rates.

"Today the key issue in minimum wage policy is not so much resolution between these two systems, which are inherently flawed and need fundamental redesign. It is whether in a global context minimum and other wages in industrialized countries will tend towards those in low-wage countries and what can be done about it.

"The real policy debate on this issue must be set in the context of competitiveness, wage levels, and standards of living, with multinational corporate responsibilities the central issue. Put differently, the issue is between onshore production, jobs and wages (hence minimum wages) versus 'offshore production, offshore minimum wages.' Debate must therefore be set in a global context and not in that of a closed economy."

John Ellsworth responds to that international note:

"Making points is certainly possible through increasing the minimum wage, but I believe that such action would,

without question, be detrimental to the country. It will drive more of the scarce jobs at the bottom of the skill ladder to offshore locations, leaving the underskilled and, in many cases, untrainable workers on the welfare lines. It would be much more beneficial to commit equal resources to upskilling as an incentive for employers to pay higher wages while continuing to operate in the United States."

Minimum Health Insurance Packages

The discussion turns to proposals that would require employers to provide a standard, minimum health-benefit package to employees. There is some possibility that the insurance industry and big business would be relatively indifferent, or might even support such legislation in Congress. In that case, small business opposition might only delay its ultimate enactment in 1989 or 1990. Ben Dial itemizes the argument against such a measure:

"The growth of the uninsured population can be attributed to a variety of factors. The service and retail industries have grown greatly. Many of these employers, particularly smaller businesses, do not provide health-care coverage to their employees. There is a lack of incentive for smaller businesses to provide coverage because of a lack of negotiating power in obtaining health-care coverage, tax inequities and higher administrative costs. There has also been a decline in the number of employees in those industries which have traditionally offered health-care coverage to their employees.

"Mandating minimum health-care levels would reduce the number of uninsured Americans. Such proposals have, however, numerous negative social short- and long-term implications that persuade us to oppose mandated benefits on both philosophical and practical grounds. Analyses of minimum coverage requirements under current proposals indicate that most employers who currently provide health-care coverage would have to modify their plans, causing disruption and increased costs (for example, expansion of coverage for part-time workers and prohibition of pre-existing conditions clauses).

"Difficulties in determining actuarial equivalent benefits will place undesirable constraints on flexible benefit arrangements. The collective bargaining process would be undercut. Management and labor should negotiate benefit coverage at the bargaining table and not be constrained through legislation. Benefit programs designed to meet unique work force needs would have to be reconsidered in order to meet mandated coverage requirements.

"Increased labor costs caused by mandated benefit levels may affect employment decisions leading to increased unemployment, reduction in the number of workers through greater mechanization, and operation with a shortage of workers when increased labor costs cannot be absorbed. Increased labor costs usually result in higher consumer prices in order to recover production costs.

"Industries competing with national and international firms which have lower health-care costs will be placed at a competitive disadvantage. The increased cost of operation is likely to discourage development of new industries and might force the closure of some current businesses.

"Passage of a federal minimum health-benefit mandate is unlikely in 1987 or 1988, although the issue will continue to be raised in the future. Governor Dukakis of Massachusetts has proposed a bill that would mandate certain health-care benefits in that state. The bill is currently stalled but may reappear. If he is successful, mandated health-care benefits could be an issue in the 1988 presidential races."

Dan Mitchell expects opposition only from small employers:

"Most larger employers have health insurance for their workers. The 1986 BLS survey of 'medium- to large-size firms' indicates that 95 percent of the firms covered had health insurance for their employees. Nearly all had dependent coverage, too. Thus, 'organized business' is not going to place a high priority on opposing mandated health benefits.

"Economic theory predicts that much of the incidence of the costs of mandatory employer-provided health coverage will fall largely on employees. That is, such programs would probably result—over the long run—in somewhat lower cash wages than would otherwise be paid. This is another reason why business may not want to invest major resources fighting the issue."

Occupational Health and Environmental Issues

The panel is about evenly divided between those who expect more "heat" on environmental health and those who view the issues as quiescent. The subject has indeed been dormant during Mr. Reagan's two terms, but a slow shift in public opinion could make it a prominent campaign subject. David Lewin distinguishes environment from work environment in his answer:

"I expect to see increased enforcement and rule-making in the environmental protection area in 1988 and especially 1989, but not in the occupational safety and health area. The former is not a conservative or liberal issue, as I see it, but rather a more fundamental value issue. As I observe the aging population (and work force) of the United States, I am reminded that age is generally positively correlated with preservational values, that is, with a concern for preserving the past. This issue has picked up steam recently, is likely to do so in the near future, and, in my judgment, will be the subject of greater enforcement and rule-making in the next year to two.

"Occupational health and safety, in contrast, is less of a value issue than a market issue. As such, and given that work injury and illness rates as a whole have declined substantially in the United States, I don't see much pressure building for additional legislation or, more pointedly, enforcement and rule-making in this area (at least in 1988 and 1989)."

Richard Belous sees more emphasis on enforcing regulations:

"The major effort in the occupational safety and health field may not be new regulations. Instead the drive could be to improve the management of federal agencies with responsibilities in this area. For example, major efforts will be made in Congress to increase the number of federal health and safety inspectors. It makes little sense to vastly increase the number of regulations on the books and at the same time reduce the ability of the Labor Department to enforce existing regulations. Similar to new programs to aid displaced workers, money for more health and safety inspectors will be one of the few areas where additional federal money will be found for labor-related issues."

Rex Adams has some strong views about regulatory matters, even in the current Administration:

"At least three aspects of these issues have been and will be 'hot.' I refer to the benzene standard, the Department of Labor's finding of 'willful' violations of OSHA record-keeping, and the High-Risk Occupational Disease Notification and Prevention Act. As the election has been approaching, the Department of Labor, in an attempt to court labor for the Republicans, has been on the wrong side of two out of three of the above-mentioned issues.

"The Department's new benzene standard at 1 ppm, for example, is more stringent than medical science would indicate is necessary. It will cost U.S. industry millions in questionable monitoring.

"The Department of Labor has gone overboard in finding willful violations of confusing regulations *re* record-keeping. Some of America's greatest companies with pioneering safety programs have been heavily fined. This behavior by a Republican Department of Labor is blatantly political.

"As to the High-Risk Occupational Disease legislation, the business community has been painfully divided over strategy. Eight months ago, the given wisdom was that this legislation by Congressman Clay and Senator Metzenbaum was on a 'fast track.' A number of major corporations and trade associations decided that it would be impossible to get the legislation off track and instead chose to work with labor. As a result, the House recently passed the bill with a 39-vote margin. A fight in the Senate, a hoped-for veto, and fight to sustain the veto lie ahead. Much preferable alternate legislation would extend OSHA's Hazard Communication Standard."

Irving Margol probably sums up the views of the panel on politics with this comment: "If Republicans remain in power, there will probably be little change. Should the Democrats take over, safety and health issues historically receive a higher priority and we can expect more aggressive enforcement and additional regulations."

Plant-Closing Regulation

There is a form of regulation of plant closings in the Omnibus Trade Bill now before the House/Senate Conference Committee. This links plant closing and protectionism as "issues." Our panel members avoid devoting their time to an examination of the final form of that bill or its chances to be vetoed. Instead, they consider the subject as a "free-standing" political and economic problem. Dan Mitchell raises the subject in the broadest terms:

"This proposal is coming down the pike in various forms and will keep on coming. We have an aging workforce. Job security is important to middle-aged workers. Neither liberals nor conservatives want to be laid off. Incumbents see virtue in their positions.

"The idea of employer obligations to employees is in vogue. Court decisions that erode the employment 'at will' doctrine are symptoms. Proposals for advance notice of mass layoffs and plant closings at the federal and state levels are related phenomena. Americans are discovering that other countries already provide some protections in these areas for employees. Economic theory, with its recent development of 'implicit contracting' models, reinforces the notion that employers owe something to workers.

"Perhaps what is lacking in the United States is a consensus on what the employment contract really contains. We have innumerable forums for deciding the issue piecemeal. New avenues of litigation arise. Old avenues—EEO, age discrimination, workers' compensation—have inadvertently become an ersatz national grievance system. I would prefer to see the issue of just what is in the employment contract discussed directly. But my guess is the piecemeal approach will continue in 1988 and beyond."

Mitchell Fromstein addresses plant closing and layoff as two separate subjects:

"Business closing, as such, cannot be restricted. There are, however, proposals to require public, advanced notice of closings where large local work forces are affected. I believe this will be done by legislation in either the 1988 or 1989 Congress. The employment trauma involved in restructuring, sale or acquisition of a business has caused a reassessment of government's role in inducing stability in employment. The issue will be 'how' rather than 'if' a company can close a plant or business.

"Layoffs, on the other hand, are an entirely different issue. It is just not realistic to prohibit layoffs by legislation. Job security and continuity in our U.S. society are a function of collective bargaining rather than law. I don't believe any legislation will arise in this area, but I do think organized labor will put a high priority on it in future bargaining."

Alan Ewalt makes a suggestion for advance notice in his comment:

"Labor hasn't had a big victory lately and I don't look

for it to occur here. This is more a subject for individual bargaining agreements than for national regulation.

"Business needs the flexibility to meet competitive situations. The evolution of the world economy amplified the need for managers to respond to meet foreign competition and manufacturing advantage. If restrictive regulations had prevented the numerous restructurings and downsizings of U.S. corporations in the early 1980s, this country would have worsened its economic outlook. Being forced to run inefficient plants or retain unneeded people could have created business failures that were unnecessary.

"Alternatively, I favor financial incentives from unemployment and federal/state job development funds to encourage as much notice as possible for plant shut-downs and layoffs to facilitate employee 'resettlement' with limited impact on the community/state/federal resources. Perhaps a credit against unemployment insurance tax could be tied to the length of notice period to produce a desired result."

Ben Dial expands on this view and links it with protectionism:

"Legislation that restricts the ability of business to close facilities or lay off employees distorts market mechanisms. It is not a cure for a loss of competitiveness or the failure of a business to grow. We need to encourage the economic vitality of each region of the country and adopt policies that help maintain the livelihood of workers in those regions. But the problems of a firm's competitiveness or reduced market share cannot be solved by restricting its ability to close, shift locations or reduce its production costs.

"Jobs and businesses compete increasingly on a worldwide basis placing us in competition with countries having abundant and cheaper labor supplies. Many labor-intensive jobs have been lost to foreign labor markets. This can be a devastating experience for individual businesses and their employees, but to artificially constrain sound business practices by preserving noncompetitive businesses will not resolve the factors that have caused the situation in the first place.

"We need to improve our productivity and quality to become the least-cost/highest-quality manufacturer and provider of services. If that strategy does not work and business closings or layoffs become necessary, we then need to work at means of reviving competitiveness, increasing employment opportunities, and developing the skills of labor—not at preserving a business that is economically not viable. In their own self-interest, government, business and labor should become partners and be the active means for increasing business productivity and product quality.

"The issue of plant closure is now being addressed in many labor contracts. This at least places the issue between the two parties most directly affected by it, business and employees. These agreements vary a great deal in their specifics, meeting individual circumstances in a way that inflexible legislation cannot.

"In spite of the many well-thought-out objections to this proposed legislation, its political appeal has not waned and we will continue to see it proposed."

Rick Belous explains in political terms why he thinks regulation will pass:

"Some watered-down version of plant-closing legislation will pass Congress. Such legislation helps a member of Congress kill three birds with one stone. First, it helps establish a record in the field of labor issues. Second, it creates the image of doing something in the area of international trade. Third, since the cost is paid by the employer, it shows the voters how a member can 'solve' a problem without expanding the federal budget deficit.

"The U.S. deficit should remain quite large for the next year. Given intense political pressures, most lawmakers feel they must respond with something. If the plant closing regulations are watered down enough, then many of the nation's leading corporations will feel less intense pressures to fight this legislative battle. Given the prospects of weak regulations larger employers will discover, in many cases, that they already have more liberal existing plant closing policies. Why should major corporations—the so-called 'A team' in the business world—expend a great deal of political capital when the companies that would benefit would tend to be smaller employers—the so-called 'B team'—of corporate America?"

Protectionism

As the United States consumes more than it produces, imports take a larger part of U.S. markets. The impulse to take direct action by limiting or taxing imports grows. And more industries seek shelter from competitors abroad, especially in the political atmosphere of a presidential campaign year.

The panel is not in favor of extending protection in the form of quotas, tariffs, etc. Dan Mitchell thinks there is little support for such a move:

"Suppose you were asked in 1979 what would happen if the dollar were to appreciate in real terms by almost 60 percent over the next six years. Suppose you were told to include in your answer the assumption that the dollar appreciation would bring about current account deficits exceeding $100 billion. And suppose you were further told to assume that even when the exchange rate began to decline, the deficit did not seem to improve. Obviously, you would have predicted massive protective legislation would be adopted.

"We rarely get to perform laboratory experiments in the social sciences, but the trade situation comes close to being one. And, although there have been some protective actions taken and others that have been threatened, it is amazing how little protection has occurred, given the 'provocations.' So, based on the evidence so far and my own assumption that the trade deficit will eventually improve, I would not predict a substantial move toward protectionism. There may be some marginal actions for particular industries but nothing wholesale. Here are some reasons why widespread protection isn't likely:

"(1) We have a new definition of comparative advantage.

The trade deficit has helped insulate the United States from the consequences of low savings (including federal budgetary dissavings). We have borrowed to maintain current expenditures. If we stop borrowing, we'll feel worse off in the short run. Politicians worry about the short run.

"(2) The flip side of the trade deficit is foreign investment in the U.S. economy. Fixing the trade deficit via protection means choking off the flow of funds into the United States from abroad and higher interest rates. It is fine for Alan Greenspan to be blamed for higher interest rates, but not so fine for a congressional representative.

"(3) Many U.S.-based firms have major multinational activities. They fear trade wars and barriers to international commerce. Thus, business interests that would have lobbied for protection 30 years ago no longer do so. (The major domestic interest group now is organized labor, which does push for protection. Capital is mobile internationally; labor isn't.)

"(4) Dollar depreciation since 1985 has pushed up real exports faster than real imports. It is the real values of exports and imports, not the nominal difference between them, that determines the effect on jobs. According to the national income accounts, real exports were up 10.9 percent from 1986-QII to 1987-QII, while real imports rose 4.2 percent. Domestic goods production over that period rose faster than imports."

Rick Belous adds:

"I don't believe that blue-collar America will have enough political force to shift the United States into a major policy of general protection. Political reality—and common sense—indicate that the better policy is one which helps blue-collar America in its difficult adjustment process. Thus, Congress can be expected to pass more bills to help displaced workers. Despite the massive federal budget deficit, money to aid displaced workers will be found."

Alan Ewalt suggests that economic adjustments and growth can stave off protectionist measures. (But a recession might have the opposite effect.)

"The growth of employment in service industries has taken up the slack of lost manufacturing jobs. Had this employment slack not been taken up, there would be much stronger sentiment for protectionism.

"The key is economic growth. If economic growth is sustained and unemployment rates are steady or declining, protectionism pressure will ebb. A recession would thrust this topic into the spotlight, punctuated with continuing unfavorable foreign trade balances.

"There is a brighter side to the balance of payments inasmuch as 'units' of export are up substantially. Because imports are more expensive per unit (due to the cheaper dollar), the actual value difference still appears high.

"The rhetoric will be heated. But regardless of who is in the White House, the threat of economic retaliation by foreign governments will keep protectionism from becoming more of a reality. It is, however, important for our government to keep rattling the sabers to keep others honest and encourage actions such as voluntary quotas, etc."

Austin Thorne gives a sound business reason for not passing trade restrictions—it damages domestic producers:

"Should U.S. manufacturing be sheltered from import competition? No. The OECD study, 'Costs and Burdens of Protection,' clearly demonstrates that protectionism is a long-term losing strategy which props up losers and leads to an obsolescing industrial structure. Bad management needs upgrading, not perpetuation."

The Most Important Human Resources Issue

At the end of the discussion, panel members exchanged views about the most important human resources issue. These individual ideas command attention because each is a product of broad background, seasoned experience and the play of committed intellect. The text below arranges these ideas in series, moving through subjects and illustrative detail toward increasingly specific issues of importance to human resources managers.

A following section contains suggestions from our panel concerning the major goal-directed activity of human resources managers—that is, what should an HR manager be focusing his or her energy on *doing* in 1988? Each quotation is preceded by the author's name.

Ellsworth:

"I believe the most critical internal human resources issue is gaining and recognizing employee commitment. Compensation, benefits design, employee health, training, union relations—all pale by comparison to the importance of gaining and maintaining employee commitment. Commitment, or lack thereof, goes to the heart of the fundamental global issue for North American businesses—the issue of world competitiveness.

"North American corporations used to value loyalty in their employee population. Promotion and opportunity were determined by length of service and serial progression up through the ranks was the norm. The 'loyal' employees approached the different hard and soft payoffs of the employment relationship as entitlements. The bigness of Fortune 500 employers represented both opportunity and security.

"With the 1980s has come the reality that uncertainty and insecurity are the new order, not just for the bottom of a flatter pyramid but also through mid and senior managers. Where effectiveness was lost in earlier years through bureaucracy, incompetent blockers, etc., more subtle but

serious impediments have come into play. These are lack of understanding of the business direction/vision; and an overall dysfunctional stress brought on by the fast-changing work environment and the social, dual-career and otherwise complex non-work environment.

"I believe that individuals want to be productive and truly deliver value for the rewards that are provided by their employer. Three essential components must be balanced in the work environment for that inherent human potential to be tapped: vision, commitment, and management. These three components are interactive in the work environment and need to be given relatively equal weight. I believe that we are fortunate to have many visionaries in North American business. Our history of success speaks well for our management systems. However, I do not think many corporations have given enough attention to understanding the commitment part of the equation.

"Commitment is not loyalty and blind saluting (do as you're told; the company knows best), lifetime employment, cradle-to-grave protection. Commitment requires having a corporate vision on the part of individual(s) at the top, pervasively translated into meaning for the individual employee. This motivates his/her giving value, while being supported by (not inhibited by) effective management talent and systems. The translation is critical. *Overmanagement* will not yield the high payoffs required. A committed employee population that understands the requirements for corporate success at each level, and that is provided with an environment to deliver against those requirements, is essential if the organization is to prosper.

"Commitment is manifested in the willing, productive delivery of human energy, not in saluting the company flag or working 12-hours-plus per day. Commitment is seen in the challenging of the old order of the day with insight, excitement, stamina, and risk-taking. I could go on and on, but I believe that almost all managers, executives, and employees can remember a time in their working life when they were committed, and I expect they could still describe their own feelings and characteristics of that environment and the productively enabling nature of it that was pervasive.

"My sense is that we are suffering badly from a lack of attention to what is being done to build and maintain commitment in our populations. Quite simply, we are just not taking time out to recall what that environment was like. In fact, we have not adjusted our antennae to recognize who is and who is not commited to our corporation's vision. Commitment must be recognized early so that selection, placement, opportunity, responsibility and accountability can be better addressed. We do not have years to decide whether an individual is worth 'betting on' if we are to compete successfully in the global village in which we find ourselves."

Thorne:

"The key internal human resources issue is the corporate treatment of people. They are generally viewed by North American corporations as a disposable factor of production.

"The Japanese have discovered that people are a corporation's greatest asset. If their talents are properly used to make continual improvements in product performance and cost, corporations benefit. The Japanese system is proving worthy of imitation."

Adams:

"It is critical to design an employee relations program that will support new business strategies, while recognizing changing demographics and employee expectations. The reality is that many employee relations programs were built in the 1960s and have not been substantially changed since that time.

"In addition to assessing the appropriateness of the written policies for the 1990s, it is necessary to challenge the custom and practice that surrounds each policy. There is need to analyze each policy systematically and in developing the new program to ensure that policies are integrated ... that they support each other.

"While the planning of change needs to be integrated, implementation (and thorough work force understanding of the changes) should be introduced incrementally."

Ellsworth:

"The realignment of resources requires some different people and cross-functional flows. It requires, most of all, a functional mindset that change can be a true ally and that no HR system needs to be considered sacred. The key to being invited back to the 'business table' will be in bringing value-adding 'business' information and recommendations, not refining some HR program or making it more sophisticated."

Fromstein:

"As I see it, today's most critical internal human resources problem is implementing and coping with radical changes that have emerged in the society and that challenge traditional work force configurations and relationships. The changes relate to worker demographics, alternative workstyles, technological change and economic imperatives.

"Today, enterprises have opted to configure a work force with heterogeneous members: a core of permanent workers to handle primary functions, with optional reinforcements such as temporary workers, part-timers, independent contractors and business-service providers. The optional workers are secured, paid and benefitted in an entirely different manner from the core workers; but are expected to adapt, relate and produce on a similar scale. The potential issues challenge management to adopt policies and procedures to deal with heterogeneity and to knit the various elements into a durable common fabric of corporate capability."

Dial:

"As technology and new developments in work processes and markets continue to change the nature of the workplace,

business must begin to make better use of retraining and job enhancement techniques to prepare its existing core work force for those changes. By better anticipating the impact of technological and other changes and by training to prepare for those changes, business can lessen disruption in the work force while increasing productivity."

Fromstein:

"Technological changes in the way work is done now demand that all human resources adapt to new equipment; use it effectively and comfortably; and grow with it as it is continually upgraded, expanded and enhanced. This is a major problem that is about to explode in the business world as major employers convert virtually all paperwork and communications to complex integrated systems covering all workstations.

"The training problem requires a new training dynamic for the organization. Human resources management must confront new systems at the planning stage and design initial training for workers before the systems are installed. Training will be an ongoing imperative. Every enhancement in systems will require reorientation for all end-users. The end-users need ongoing support in how to use systems with skill and to maximize system capability. (And, incidentally, solve the problem of orienting non-core staffers to these complex systems.)"

Dial:

"Business needs to work closely with government, labor and the educational system to ensure that those entering the work force receive the kind of education on which business can build in its own training programs. Without this kind of cooperation, the work force will not have the kinds of skills needed in the high-tech industries and international markets of the future. Businesses that do not recognize and plan for the potential mismatch of skills to jobs will face severe staffing problems.

"Just as the core work force must be properly prepared for the impact of change, so must our country's business executives. It will be critical for business leaders to be persons of vision who understand these changes and can effectively implement them to ensure the continued health of business in the United States."

Lewin:

"I expect labor shortages to be the single most critical 'human resources' problem facing U.S. businesses in the next several years. Beyond this, several other HR problems are also important including the screening of current employees, maintenance of employee commitment, and the viability of performance appraisal systems.

"Most firms now test applicants for drug use, some firms test applicants for 'honesty' via polygraphs, and a few firms test applicants for AIDS. In a very real sense, such applicant testing is a simple problem even though the result of testing in the aggregate is to reduce labor supplies and impose upward pressure on compensation. The much thornier issue involves the testing of *current* employees in any of the aforementioned respects. Such tests may violate the implicit employment contract, create interorganizational conflict, place added pressure on employee assistance programs, and make the supervisor's job more difficult.

"In the future, most employees will no longer view an enduring commitment to the employer as a central life value. Rather, the growing emphasis will be on the acquisition of general skills that employees can transfer among competing employers, depending in part on the best offer received. In the near future such mobility may result in quantitative and qualitative labor shortages that prevent firms from achieving their business objectives.

"As to performance appraisal systems, while most of these are oriented toward the measurement of individual employee performance, they typically do not measure direct performance. To the contrary, most performance measurements take the form of supervisors and managers' ratings (or rankings) of employee performance. However, growing emphasis on the measurement of group, unit and organizational performance and on after-the-fact compensation (via bonuses, for example) raises serious questions about traditional performance evaluation systems and formats."

Ewalt:

"We are confronted with a significant labor shortage of care givers in acute-care hospitals, i.e., nurses, physical therapists, occupational therapists. In certain areas, particularly the Northeast, we face shortages of unskilled people in housekeeping and dietary, as well as nursing. Low unemployment in the Northeast has made competition for unskilled workers very expensive—if we can find workers at all. Inducements to hire and retain (such as bonuses, contingent workers, special benefits) keep getting more and more expensive and jobs still go wanting in the Northeast.

"There is a decline in the level of interest in the nursing field. There is a smaller group of young people entering the work force. Women are pursuing alternative careers rather than the traditional nursing, teaching and clerical work.

"Occupancy in acute-care hospitals has declined over the last three years telegraphing the message to young people that opportunities in health care would be more limited than they have turned out to be. Pressures are to increase wages, to improve retention and, through other mechanisms, to attract additional people to the labor force.

"Without nurses, the quality of health-care delivery will quickly erode. There is some attention to redesign of the nurse's job to provide greater satisfaction and authority to act. Thus far the effort has been limited by existing medical practice patterns and efforts by the American Medical Association to keep nurses from encroaching on the practice of medicine."

Margol:

"Pay for performance is the most critical human resources issue internal to corporations today.

"Employees expect to be rewarded through annual merit increases. Employers, however, are objectively measuring the bottom line and assessing the value received for their human resources investment. Management's perspective is, 'if the bottom line does not support increases, there should be none.'

"Incentive plans are becoming common practice. Once incentive plans are instituted there is the possibility that teamwork is destroyed and self-interest arises. 'Following the buck' is becoming the common employee response to incentives.

"With compensation and operating expenses increasing at a greater rate than income (in our industry), controlling compensation and other operating expenses is a major business issue.

"Although I personally hate the expression 'pay for performance,' this statement addresses many facets of the issue: What is the compensation philosophy of the organization? What does it value? If you can measure it, shouldn't you reward it? Should you reward an individual or team for its performance, even if the total organization doesn't reach its goals?

"Unbundling the compensation program of an organization to address its parts puts the HR executive in a pivotal role. He or she must define a program that can assist management in reaching its goal of increasing income and controlling expenses and design a tool that maximizes an employee's compensation in direct relation to his or her accomplishments."

Adams:

"Today, human resources managers should be tightly focused on two objectives of overriding importance. The first is to assure that every significant unit of the organization is being competently and effectively led by managers who are held to exacting and non-fudgeable performance standards. I stress not only the necessity to improve performance, but the urgent requirement to support the legitimacy and credibility of the management function.

"One of the more enduring themes of the industrial restructuring effort has been emphasis on the linkage between performance of the company, on the one hand, and job security and rewards for employees on the other. In industry after industry that lesson has been driven home as jobs have been lost, pay and benefits have been cut, and reward systems have been reoriented for closer alignment to firm profitability and performance. In this environment weak or inefficient management is not tolerable and the assurance of management quality becomes a compelling task."

Margol:

"With a climate of downsizing, mergers and acquisitions, global competition, values and ethics, and productivity, the HR executive should be devoting his/her energies to:

"(1) Crystalizing his/her pivotal role as the linking pin between management's expectations and the employee's concerns. It is more important than ever that employees sense 'a place to go' and a voice to represent them, as it is for management to feel that they are making human resources business decisions with valid 'people' data.

"(2) The HR executive must be a business partner both in redesigning the organization for effectiveness and efficiency, and in assisting in the selection of the people best suited to perform the job."

Fromstein:

"Human resources managers must become agents for change rather than simply administrators of policies.

"Dealing with a hetero-staffed organization requires a deep understanding of the various optional worker groups: their characteristics, how to manage them well, how to select the best resources, how to measure their work contributions, how to relate them to core workers. Human resource managers must have plans for integrating optional workers into the production stream."

Ellsworth:

"HR managers must focus on aligning the resources they have on the 'business' and away from administering compensation, benefits and labor relations. This will require a significant change in the players that populate the function, a dramatic shift to utilizing technology, and a 'get your feet wet in the business' credo.

"If HR managers redirect their staff to understand the business there are tremendous payoffs to be gained from cleaning up or trashing bureaucratic management processes, from better matching of individuals to positions, from understanding an individual's competency profile and using positions that develop the weaker competencies, from leveraging the compensation dollars that *are* being spent through aligning compensation delivery with the business direction, and, above all, from coming to the table with actionable insights to couple the individual's human potential to the business direction."

Adams:

"I think human resources managers in industrial firms, in particular, need to be very mindful of the actions required to assure the continuity of their organizations. We have all been so preoccupied with restructuring and downsizing that we have not had either the time or the resources available to put into place programs for the future. Recruiting has been either eliminated or de-emphasized; training has been neglected; planned career development moves have been reduced; and, in many cases, the quality of organizational life has deteriorated. As human resources people, we have

got to begin to revisit these issues and put in place programs that anticipate the needs of our organizations in the 1990s and beyond."

Mitchell:

"Human resources professionals ought to be playing an active role in the redefinition of the human resources manager function itself.

"Historically, the status of human resources managers was elevated because of *external* challenges: unions, and later government regulation. Such challenges tend to put the human resources executive in the role of either police officer or fire fighter and trouble shooter. Human resources is important in that role, but it is also viewed as a nuisance. HR staff inevitably becomes a bureaucracy that tells line managers—who are trying to get the product out the door—what they can't do or what they must do.

"If human resources managers can be viewed as meeting *internal* challenges, rather than only external, it is much easier to make the case for incorporating human resources managers' considerations into the firm's strategic planning. Issues of cost control and productivity are ready-made internal challenges for the 1980s. To deal with such issues, however, HR managers need to become more numbers-oriented and analytic.

"Quantification should not be the exclusive province of financial analysts and accountants. Computerization in the human resources field should mean more than just efficient ways to keep payroll records. Here are some questions which human resources managers ought to be able to answer: What does turnover cost? Absenteeism? How would turnover respond to a given pay increase? What impact is the pension plan having on retirement patterns? Have innovations such as quality circles actually raised productivity? In any case, what explains productivity variations across plants? How much should the firm be spending on training? How much is it spending now? These are all bottom-line questions; the better they are answered, the more important the human resources staff will become.

"Key decisions such as what to produce have human resources implications. Production decisions determine the occupational mix of the firm's work force. How will the needed occupations be obtained? From the external labor market? If so, do current projections suggest difficulty in recruitment? Locational decisions ought to be matched with census and other data to determine the compatibility of labor supply and demand."

Thorne:

"Human resources managers should focus on:

"(1) How to harness people more effectively or compensate them properly for positive and effective contributions to growth;

"(2) Comprehensive advance planning for technological change including advance retraining and early retirement;

"(3) Developing cafeteria-style benefit packages."

Dial:

"Along with the issues raised above, human resources professionals should be actively dealing with issues concerning the growing expenses associated with health-care costs. Although we have had some success in containing health-care costs, the growing unfunded medical and other health-care liabilities of current and retired employees must be addressed. Bringing these costs under control and devising ways to share these costs with the employees using them is a priority. Legal and tax code changes are another way to lessen this burden on some employers and equalize it for others.

"Businesses must also work with health-care professionals and government to find ways to control the extraordinary growth in the cost of health care. It is essential that the parties mentioned above work together to find ways to ensure that the best medical care is available to our work force without bankrupting business.

"The use of wellness efforts by American business is a creative and inexpensive way to begin to address some of these problems by dealing with health risks before actual medical intervention is necessary. However, much more needs to be done."

Lewin:

"Human resources managers face a problem that presents a fundamental dilemma. On the one hand there should be growing emphasis on integrating HR considerations into an organization's strategic business plan. On the other hand, if this is fully pursued it strongly implies that fewer HR professionals and staff will be required in the typical organization. In other words, the idea that line managers should take human resources considerations more fully into account in planning for and operating the business is accompanied by the related idea that HR functions and staffs should be 'downsized!'

"I do not expect HR managers to go out of business in light of this development, but there might be a reduced demand for their services as knowledge of HR planning and HR management becomes more widely diffused in business organizations."

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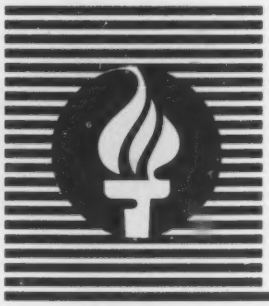

The Conference Board

U.S. Economic Outlook, 1988

12-member Economic Forum forecasts:

- *real growth of 2%*
- *inflation steady in 4% range*
- *little change in interest rates*
- *odds against recession, but...*
- *uncertainty quotient up in market's wake*

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Dark Clouds and Silver Linings

Edgar R. Fiedler

The mid-October collapse in stock prices may or may not turn out to be a signal of serious trouble ahead for the economy, but it certainly has made trouble for economic forecasters. Every topic discussed at the fall meeting of The Conference Board's Economic Forum was heavily colored by the drop in equity prices. Every component of the forecast was analyzed in terms of "BC" and "AC"—before the crash and after the crash.

Although it was not a unanimous finding, members of the Forum reached a clear consensus that the 1988 outlook has weakened. We do not believe, however, that this loss of economic energy is sufficient to cause a recession. In our minds, although the risk is now larger, a recession is still a possibility rather than a probability. In this sense the uncertainty that always surrounds an economic forecast has now escalated sharply. This was the most important immediate effect of the Wall Street shock on the economic outlook.

The major reason for a weaker 1988 outlook is the anticipated decline in demand for both consumer and capital goods. Most of the discussion within the economics fraternity has centered on what is called the "wealth effects" on consumers. This is the idea that stockholders, having seen a substantial part of their perceived wealth disappear, will respond by curbing current spending. That impact is estimated to cut three to seven cents out of consumption for every dollar of lost equity value. Capital investment demand will fall in a similar fashion.

Forum members doubt, however, that the cause and effect works quite that way. The proportion of households with substantial equity holdings is very limited, and those with large portfolios of stocks are unlikely to change their spending habits much in any event. Thus the main impact on consumption almost surely comes not from the loss of perceived wealth, but from the anxiety and uncertainty generated by the market collapse and by the confusion that prevails about why it happened. Seeing that no one can explain it persuasively and seeing the experts disagree vehemently on both the causes and cures, consumers find the event very unsettling, even when it doesn't directly affect their own wealth. In response, some postpone the big-ticket purchases they had been planning. It is this heightened anxiety, this loss of confidence in the economy, rather than diminished equity values, that is the primary reason for a weaker economic outlook.

In addition to the collapse of stock prices, the economic skies contain a couple of other dark clouds. One is the risk that closing the federal budget gap in 1988 may come at just the wrong time. None of us doubts the need to reduce the large budget deficits to assure the long-run health of the economy—the national saving rate looks more anemic than ever—but neither does anyone want this to take place too abruptly when a recession may be developing.

Finally, there is a negative side to the falling dollar. It adds to inflationary pressures here in the United States and dampens economic demand for our trading partners. Since most other industrial nations are more dependent on exports than we are, any significant curtailment of international demand increases the chance of worldwide recession.

Edgar R. Fiedler

"A clear consensus that the outlook has weakened."

Favorable Offsets

At the same time, Forum members found some silver linings in the dark clouds. (One member of the group referred to the silver linings as "disguised blessings," but those among us who are closest to the stock market thought the blessings were very well disguised indeed!)

The most important of the recent favorable developments is the substantial decline in interest rates—more than a percentage point for all maturities. The Federal Reserve, in an effort to ensure stability in the financial markets and thereby minimize the risk of recession, has provided the financial system with plenty of liquidity. At the least, this easing of borrowing costs removes the negative impact of the tightening of credit that took place during the preceding half year. Some members of the group, however, took more encouragement than that, feeling that the easing of credit will generate a revival in home-building and other construction.

It is worth noting that formulation of monetary policy after the collapse on Wall Street involves a nice irony. When Alan Greenspan was appointed Federal Reserve Chairman, a few observers criticized the choice on the grounds that Greenspan was too close to the Reagan Administration and thus might, for political purposes, be willing to risk inflation by flooding the financial markets with liquidity. Then came October 19, and he did, and those same observers loudly applauded him for it.

Another positive development for U.S. economic activity, and especially the goods-producing industries that operate in international markets, is the further slide of the dollar in foreign exchange markets. This drop continues the trend that was

The Forum Consensus
Results of a Pre-Meeting Outlook Survey

	Actual Percentage		Projected Percentage		
			Fourth Quarter	1987	
	1986	III 86-III 87	1987	Median	Range
Economic Growth (Change in Real GNP)	2.2%	3.0%	2.4%	2.0%	1.2 to 2.8%
Inflation Rate (Change in GNP Deflator)	2.2	2.7	3.2	4.0	3.3 to 4.5
Corporate Profits (with IVA & CCA) (Change before taxes)	1.2	5.0	5.0	3.0	–9.9 to 8.6
Unemployment Rate (Average during final quarter)	6.8	6.0	6.0	6.3	5.9 to 7.0
Commercial Bank Prime Rate (Average during final quarter)	7.5	8.3	8.6	8.75	6.0 to 9.5

	Actual Median		Projected Median	
	FY 1986	FY 1987	FY 1988	FY 1989
Federal Budget Deficit (Billions of dollars)	$221	$148	$172	$165

Note: These forecasts incorporate submissions by Forum participants in early November, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percentage change over the four quarters of the year, i.e., from 1987 IV to 1988 IV; the forecasts for the fourth quarter of 1987 are at seasonally adjusted annual rates.

in place prior to last February's Louvre agreement to stabilize currency values. Accordingly, the improved international competitive position of the United States will be reinforced, further stimulating our exports and curtailing imports to the advantage of domestic producers.

A third beneficial change is the abating of inflationary pressures. The same uncertainty and apprehension that will slow the growth of consumer and capital-goods spending will also make business executives more cautious when considering price increases. Similarly, workers will be slower to ask for bigger pay hikes and managements more reluctant to grant them. Because prices of imported goods are rising and because the economy has moved close to full capacity operations, inflationary pressures are on the rise, at least moderately. But whereas the Forum might previously have called for 5 percent inflation during 1988, our post-Wall-Street-debacle consensus holds the inflation forecast for next year to 4 percent.

Still another silver lining is to be found on the political front. Just as the stock market break changed the economic forecasts, so did it alter the Washington environment for policy-making. For example, the market break brings back recollections of the highly protectionist trade legislation of the Great Depression: the infamous Smoot-Hawley Act. This reminder improves chances that the 1987 trade bill will end up with fewer egregiously protectionist clauses. The Gephardt amendment, for instance, is nearly certain to be replaced by one proposed by Senators Danforth and Riegle. What's the difference? "Danforth-Riegle" has been described as "Gephardt" in a three-piece suit, with clean fingernails and better manners! Danforth-Riegle, in other words, addresses the same grievances as Gephardt but tries to do so without being as big an obstacle to continued progress in developing an open and efficient international trading system.

A second result of the changed Washington environment was the serious budget negotiations between the White House and Congress that produced a compromise agreement shortly after the Economic Forum meeting was held. Whether this will produce a meaningful reduction in the deficit is not clear, but at this writing it is difficult to be optimistic. The bargainers seemed intent primarily on maintaining the time-honored political tradition that the tough issues must be avoided. They thus bypassed a golden opportunity to make a sizeable long-term dent in the deficit and achieve a fundamental reordering of spending priorities. Nevertheless, by forcing the politicians back to the bargaining table, the stock market break at least made it possible to achieve more of an improvement in the budget situation than the ham-handed outcome ordained by Gramm-Rudman.

Conclusion

In their forecast for 1988, although they do not look for a full-fledged recession, members of the Forum do expect a noticeable slowing of the pace of expansion. The median projection calls for a 2 percent growth through the end of 1988, a rate that is quickly becoming the new consensus among forecasters. This slow growth makes us anticipate a slight rise in unemployment—to about 6.3 percent by late next year. Further, it is a growth rate that seems consistent with the level of interest rates moving either higher or lower, but not by very much. And the inflation rate, as mentioned earlier, is expected to inch upward to about 4 percent.

It bears repeating, however, that the uncertainty surrounding these estimates is higher than usual. In particular, the risk of recession has increased. A major determinant of the risk is how the budget is perceived. Whether or not the deficit was a direct cause of the October turmoil on Wall Street, it since has become the focal point of public discussion about what ought to be done. In the end, if the final compromise on the deficit is viewed as a decisive and significant start to dealing with the problem, public confidence may be restored and spending on consumer and capital goods will be in a position to go forward in normal fashion. Alternatively, if the public perceives the budget result as nothing more than the usual Washington song and dance, confidence in the economy will be stretched even thinner.

Although the budget result is only one of several imprecisely measurable influences that will help shape the 1988 economy, it is presently the most visible and thus the one creating the most suspense. If this issue is resolved satisfactorily, other uncertainties will remain, but economic prospects for 1988 will look surprisingly benign, much more so than we might have expected in the wake of a 30 percent decline in stock prices. Without meaningful progress on the budget, the risks of serious economic trouble are raised further.

After the Crash

J.W. Anderson

In the political world, as well as in the markets, the climate was transformed by October's crash. Dangers that previously seemed theoretical and remote to Washington are now unpleasantly urgent. The people who make national policy pretty well agree—with the notable exception of President Reagan—that U.S. consumption is going to have to be reduced.

To understand Mr. Reagan it's helpful to realize that he considers economics to be essentially subjective—a matter of attitudes, opinions and expectations. The idea that there is any hard or inescapable cause-and-effect in the machinery is foreign to him. He is completing a brilliant career in which he consistently prospered by ignoring economists' advice, and it's hard for him to accept that the present situation is any different. This makes him slow to move.

One consequence of this situation is that strong leadership from the White House is unlikely. It seems more probable that the White House will use its influence to resist or to support initiatives that originate elsewhere, perhaps in the Treasury, the Federal Reserve or in Congress.

While most ranking politicians other than Mr. Reagan acknowledge the need to cut back consumption, one critical issue is whether this will happen in the next 14 months—that is, in this administration or in the next one. The current tax quarrel is really over whether it happens now, by design, or later, by inflation and, probably, recession. Often in American politics

J.W. Anderson

"Dangers that seemed remote are now unpleasantly urgent."

Congress can be legitimately accused of taking the short-term view, while the President, thinking of his place in history, takes a longer perspective. But the President is coming to the end of his term, and those positions have been reversed. The President and his administration are going to try, at any cost, to hold things together for another 14 months without much thought as to what happens next. Congress, on the other hand, is run by people who expect to be around after January 1989. And, while nobody wants a recession before the election, they are beginning to worry about what will come thereafter.

The basic dispute over spending and taxes is not going to depart with Mr. Reagan. Public support for higher taxes is

usually a response to war or social crisis. The past 14 years in this country, however, have been a time of peace and relative serenity in which the sense of a common purpose has faded and consequently resentment of taxation has risen. Mr. Reagan only reflects this attitude; his successor must deal with it.

As for spending, it is driven by defense and the realities of an older and larger population. The part of the budget that is neither defense nor Social Security was combed out thoroughly and harshly beginning in the Carter years. Even the Reagan administration is now convinced that there are points at which significant expansion of federal responsibility is necessary. Catastrophic health insurance is an example. As Mr. Reagan has discovered, there is little support in either party for cuts in social spending below the present levels.

For some time financial people have been telling the politicians that if Washington can't get the economy back into reasonable balance, the markets will do it for them. That process, Washington now fears, may have begun. The consensus holds that cutting the budget deficit is crucial. But there's little confidence at this point that deficit reduction alone can return the U.S. economy to the safe, stable track it seemed to be following as recently as last summer.

Social and Political Trends Worldwide

Paul Kreisberg

Three major forces are influencing political and social trends virtually everywhere in the world—uncertainty about the world economy, concern about debt burdens and the political pressures they are producing, and the prospects for U.S.-Soviet detente.

The mood is not one of panic or deep anxiety about imminent economic collapse—Soviet policies since Gorbachev have actually diminished fears of war—but of growing unease about the threat of sudden economic reversals that could be deeply unsettling politically. Criticism of the United States' economic policies and a number of its foreign policies has grown, helping increase nationalism in many countries. Thus far there is no fundamental danger to the broad political relationships between the United States and its allies, but cautionary signs are again visible.

Africa is the darkest of the continents, as usual. Glimmers of economic reform that shined only a few years ago have dimmed. Heavy official debt, declining aid flows, slower economic growth, mounting racial tensions in southern Africa, domestic political unrest, and the menace of AIDS, which threatens the educated infrastructure of east and central Africa, give no ground for African optimism about the next decade.

Latin America is obsessed with intractable problems of debt, drugs, internal instabilities and the uncertainties of the international economy. The enthusiastic welcome given to democracy by Argentina, Brazil and some of the Andean states is weakening under austerities imposed by debt and the IMF. Prospects for growth, democracy and political stability from Mexico to the Southern Cone are increasingly uncertain.

A real political settlement in Nicaragua and El Salvador would come as a relief to the leaders of all countries in Central America. However, there is strong regional skepticism that insurgencies—popular or externally encouraged—will disappear, that the Sandinistas will accept democratic reform, or that there will be a new surge of economic growth that will contribute to long-term political stability.

Paul Kreisberg

"The world continues to ask the United States to pick itself up and behave like a leader."

Europeans are intrigued by the new Soviet style and anxious to expand detente and trade with both Moscow and Eastern Europe. Nationalism is growing in Europe, along with a determination not be tumbled around by shifting U.S. foreign policies. Europeans accept the importance of economic and political policy coordination among the major powers but want this to serve the interests of all, not primarily an America reluctant or unable to bring its own fiscal and macroeconomic policies under control. Economic uncertainty, symbolized by the volatility of the stock and foreign exchange markets and the U.S. counsels divided over macroeconomic policy, combined with political uncertainty symbolized by the fading influence of President Reagan, the prospective Reagan-Gorbachev summits and their prospective influence on allied defense strategy, and the swarm of U.S. presidential candidates, few of

whom are well known to Europeans, is particularly unsettling.

In Asia the economic situation is generally good, although the future seems more uncertain and political problems have increased. Healthier commodity prices, higher GNP growth (still led by exports), new capital flows from Japan, and relatively stable price levels have kept economic confidence reasonably high in most of the countries of East and Southeast Asia, although they are fearful of Western recession and protectionism.

Political institutions are under pressure in Korea, where the effort to democratize the society is still being tested; in the uneasy mix of multi-ethnic societies of Malaysia, Sri Lanka and Fiji; in the Philippines, which remains beset by unemployment, rural poverty, a deeply entrenched insurgency and political factionalism that now extends to the armed forces; and in much of the Indian subcontinent where ethnic, religious and linguistic forces remain divisive and frequently violent.

At least for the time being, China has overcome conservative resistance to economic reform and is successfully making the transition to a new generation of political leaders. Japan is emerging from the first major round of fundamental economic restructurng and has at last begun to assume greater international political as well as economic responsibility. The economic costs include growing popular resentment against sharply rising land prices, higher unemployment, and questions about economic and social priorities. The pace of social change in Japan is going to continue its acceleration. As in Europe, an accompanying element is a newly emerging nationalism, embracing an increasing Japanese self-assertiveness, a reluctance to be "pushed around" by the United States, and an awareness of the importance of Japan to Asian and global economic health and growth.

Overall, the rest of the world continues to ask the United States to pick itself up and behave like an international and political leader but has diminishing optimism that this will happen quickly. Consequently, there is growing concern about what other states (e.g., Japan) and groups of states (e.g., the EEC) can best do to help themselves and each other.

The Cyclical Setting: Winding Down?

Allen Sinai

After sixty months of expansion, the second longest business upturn in postwar history is in danger of winding down. Despite this year's economic performance—the best since 1984—the odds increasingly favor a major slowdown or recession in 1988 or 1989.

Part of the explanation lies in huge internal and external economic imbalances—for the United States, continuing large budget deficits and seemingly intractable trade deficits and for Japan, Germany and increasingly the newly industrializing countries, large trade surpluses. These imbalances have set into motion major gyrations in currency exchange rates, interest rates and stock prices—ultimately to correct what the countries themselves seem unable to alter.

For the United States, market prices are doing what policymakers have not done, setting up forces through high interest rates and lower stock prices to cut back domestic spending and to increase savings in order to finance the budget and trade deficits. Weaker growth or a recession in the United States, in turn, can weaken other economies where stronger currencies and high interest rates are already keeping growth low. The adjustments and risks in such a process are considerable, most likely is a major worldwide slowdown or a recession, with the risk of something even worse.

Allen Sinai

"A major worldwide slowdown or recession, with the risk of something worse."

The Stock Market Crash

The stock market crash, in retrospect, was an essential part of the process. With the budget and trade deficits still high, interest rates rose and were expected to push higher, which caused the stock market to tumble. Other factors were important, but that was the key. With the size and scope of the stock market declines unprecedented for the postwar period, the cyclical setting for 1988 has been radically altered and a winding down of the expansion set into motion.

The cyclical setting in this instance is not the typical pattern. There was no overheating—no full-employment excesses, such as an overbuilding of inventories, sharply higher inflation or a credit crunch. Instead, a deflationary and recessionary shock, the "Crash of '87," has set the backdrop for 1988.

The standard scenario for 1988, based on the better and more balanced expansion of the U.S. economy in 1987, lies in doubt. In this scenario, relatively strong growth, rising inflation, higher interest rates and approaching full employment would culminate in a recession some time in 1989, for the usual reasons. These include (1) full-employment pressures in labor and product markets, (2) rising prices and wages, (3) higher interest rates and possibly an inverted yield curve, (4) deteriorating financial positions of households and businesses, (5) excesses in spending and borrowing that need to be corrected, and (6) an ever-tightening Federal Reserve policy. Complicating the prospects this time around is the global factor—the interactions of so many world economies and financial markets in new ways, especially as focused on the dollar.

But the stock market crash changed these prospects, suggesting an autonomous negative shock to consumer spending and, possibly, other negative events in the United States and worldwide that can wind down expansion. The stock market has been a good indicator of future turns in economic activity, although it generally overpredicts recessions. Of 13 bear markets in stocks during the postwar period, 8 have been followed by recessions. Notable exceptions occurred in the aftermath of the stock declines in 1961-1962, 1966, and 1977.

The stock market is a key leading economic indicator because of its cause-and-effect relationship with the economy. It impacts household net worth, consumer sentiment, cost of business spending, new incorporations, and other financial and real markets.

Approximately $1 trillion of household net worth has been wiped out by the October crash. Assuming nothing much worse or better happens than the stock market crash in the United States and so far abroad, a major economic slowdown is indicated and would be reflected principally in lower consumer spending, softer residential construction, unwanted build-up of inventories relative to sales, weaker business sales and corporate profits, some retrenchment in capital spending, slowdown in the manufacturing sector, weakness in economies abroad, and, finally, major worldwide slowdown or recession. The one bright spot for the United States should be a substantial improvement in the trade deficit, based on large reductions in imports and stability in exports. In this scenario, the stock market crash can accomplish what policy and discretionary choices did not—the slowdown in domestic spending necessary to improve the trade deficit.

A Different Winding Down

Unlike other business cycle expansions that typically end through a combination of too rapid expansion, overheating, full-employment barriers, rising inflation, rising interest rates, inverted yield curves and policy errors, the setting for 1988 is quite different. Here, the winding down of the expansion is taking another form, precipitated by a financial recessionary shock similar perhaps to the credit controls of 1980. Though superimposed on a backdrop of a potentially negative process, there is no inherent reason why a downturn must occur, depending on the policy response.

The uncertainties generated by the stock market crash and its effects around the world make the cyclical outlook for 1988 most difficult. Whether the stock market declines persist or worsen, how the shock impacts and with what lags, will be determined by the response of policies in Washington, Bonn and Tokyo, the global effects and financial interactions, how the normal business cycle processes work out, and the role of full employment. The crash can possibly further events in the cyclical process and provide an important part of the backdrop for economic and financial market prospects over the next year.

Expansive Monetary Policy Needed

Andrew F. Brimmer

In light of October's sharp plunge in the U.S. stock market and of continuing instability in financial markets, the Federal Reserve should maintain its easy monetary policy over the next several quarters. The Fed's principal objectives should be to avoid recession and to promote a moderate rate of economic growth. The Fed should not lose sight of two other important goals: (1) preventing a resurgence of inflation and (2) contributing to an improvement in the pattern of U.S. international transactions. However, the main emphasis should be on the use of monetary policy to ensure the adequate availability of money and credit and to reduce the level of interest rates.

Andrew F. Brimmer

"The Fed's objectives should be to avoid recession and promote growth."

The impact of the 1987 stock market collapse on the overall economy is hard to gauge. Nearly all of the previous twelve sharp decreases in stock prices since World War II have been followed by a slowdown in economic activity. In eight instances, an actual recession occurred—roughly ten to twelve months following the peak in stock prices. The decline in stock prices erases part of household's net worth and creates uncertainty about the outlook for jobs, sales and profits. In response, both consumers and businesses tend to cut back on spending.

In light of this, one should expect the sharp 1987 decline in the U.S. stock market (which paralleled a similar decline in stock prices abroad) to dampen U.S. economic growth in 1988. Prior to the severe drop in stock prices in October, Brimmer & Company had forecast real GNP to rise by about 2.6 percent in 1988. The decline in market values through mid-November suggests that next year's growth may be kept to roughly 1.5 percent. Real consumer spending might rise by 1.3 percent (vs. an earlier projection of 2.3 percent), and business fixed investment by only 1.7 percent (vs. 3.5 percent forecast earlier). Exports may expand by 9.2 percent (vs. an expected 10.0 percent), and imports may decrease by 1.0 percent (vs. an increase of 1.7 percent). On the other hand, despite strong efforts for an actual reduction in the U.S. budget deficit, federal government spending may rise by 0.5 percent (vs. 1.0 percent).

In the context of more sluggish economic growth, inflationary pressures would be slightly less. The GNP deflator might rise by 3.0 percent in 1988 (vs. 3.6 percent projected earlier) and the consumer price index by 4.2 percent.

Slower economic growth most likely means higher unemployment. The civilian unemployment rate in 1988 was originally projected at 6.0 percent. Instead, it may average 6.3 percent—slightly above the 6.2 percent now anticipated for 1987.

Role of Monetary Policy

Given the outlook for the nation's economy, the Federal Reserve should pursue an expansive monetary policy well into 1988. Immediately following the plunge in the stock market, the Federal Reserve moved aggressively to supply additional reserves, and it announced its commitment to provide whatever liquidity might be needed to stabilize the market. In carrying out this policy, the Fed undertook an average of $6.0 billion per day in repurchase agreements during the week ending October 21, and the daily average was about $12.0 billion in the week ending October 28. To cope with seasonal requirements, the daily volume of repurchases in October would ordinarily average roughly $2.0 billion.

A tightening of monetary policy in late August and early September contributed to the erosion of stock prices. Monetary policy had been generally restrictive since the spring, and the pressures on bank reserves had increased over the summer. For instance, from January through May 1987, total reserves expanded at a seasonally adjusted annual rate (SAAR) of 9.3 percent. But, after the Federal Reserve became less accommodating, total reserves shrank by 2.7 percent SAAR between May and September.

Finally, on September 4, the Federal Reserve discount rate was raised from 5.5 percent to 6.0 percent. In announcing the increase, the Federal Reserve Board stated that the move was made to forestall the strengthening of inflationary expectations. This action gave another boost to interest rates and reinforced uncertainty among investors regarding the outlook for stock prices. It also helped to trigger the sharp decrease on October 19.

In response to the subsequent easing of monetary policy, interest rates declined noticeably. For example, on Friday, October 16, the Federal funds rate averaged 7.50 percent, and three-month Treasury bills averaged 6.81 percent. In the long-end of the market, 30-year U.S. Government bonds were yielding 10.22 percent. By November 10, federal funds were down to 6.56 percent, and three-month Treasury bills were down to 5.66 percent. Thirty-year U.S. Government bonds were yielding 8.88 percent.

Looking ahead, we expect Federal Reserve monetary policy to remain expansive. It is anticipated that bank reserves in 1988 will expand substantially faster than was the case this year. The monetary aggregates will also expand more strongly. The Federal Open Market Committee (FOMC) has set a range of 5 to 8 percent for the growth of both M2 and M3 in 1988. (The range for both in 1987 is 5½ to 8½ percent.) Because of the commit-

ment to help avoid a recession, the actual growth of the monetary aggregates in 1988 may reach the upper part of the range, indeed may even exceed the 8 percent ceiling.

Under these circumstances, the level of interest rates can be expected to decline noticeably. The federal funds rate (which may average 6.65 percent in the fourth quarter of this year) may be down to 5.15 percent by the end of next year. Three-month Treasury bill yields may decrease from 5.50 percent to 4.85 percent. The commercial bank prime rate may be cut from an average of 8.50 percent over the same period to 7.15 percent, and 30-year U.S. government bond yields may decrease from 8.75 percent to 8.00 percent.

We Done Got Our Ox in a Ditch

Edward M. Gramlich

In my first week at the Congressional Budget Office in early 1986, I accompanied then-Director Rudy Penner to a hearing before the Senate Budget Committee. At one point, in his inimitable southern drawl, Senator Fritz Hollings asked whether Penner didn't think "We done got our ox in a ditch." Not a bad way to put it, Senator. So how is the ox doing two years later?

It's still in the ditch. America's basic economic problem involves national saving and investment. The accompanying chart shows national saving and investment, both net of depreciation and as a percentage of net national product. The drop in net national saving is sharp, from 11 percent back in 1950, or 1973 for that matter, to barely more than 2 percent so far in 1987. The drop in net investment is not so sharp, from 12 percent in 1950, or 9 percent in 1978, to 6 percent so far in 1987. The difference in investment and saving reflects foreign borrowing and the enormous trade deficit.

The main cause of the problem on the saving side of the ledger is the federal deficit, which has accounted for about two-thirds of the drop in net national saving from the late 1970s—but for only two-thirds. There has been a drop in private saving that augmented the federal dissaving. I see in this a small blessing and a large problem. The small blessing is that those who believe in the unlikely concept of Ricardian equivalence (deficits don't matter because private savers will offset them) have some embarrassing numbers to confront. The large problem is that in their personal finances households seem to be afflicted by the same over-consumption disease that is afflicting them in their political choices. Perhaps the deficit is not a cause but a symptom of something deeper.

I call overconsumption a disease because I am quite worried about it. I cannot prove the nation is overconsuming because consumption and saving decisions, whether personal or political, involve trade-offs between present and future living standards. Who is to say what is the right saving ratio? But though I cannot prove the United States is overconsuming, it is saving less than other countries, less than it used to, and less than is required to maximize living standards over time. There is no proof of overconsumption, but plenty of suggestive evidence.

Edward M. Gramlich

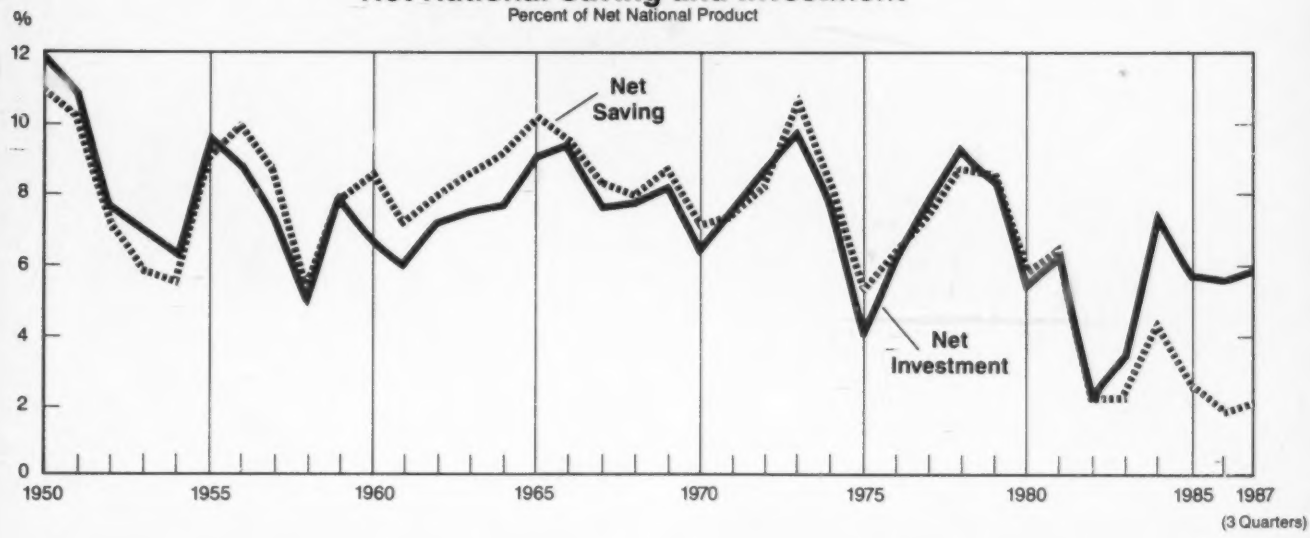
"Worried about the over-consumption disease."

This problem has been more widely recognized recently, but there are still several reasons why any burst of optimism might be premature: So far the true decline in the deficit is modest. Much of the improvement in fiscal 1987 was in items that make only a one-shot change. Perhaps because of this, there is still little change in the underlying rates of national saving and investment which, I argue, represent the true problem. Both the unified deficit and overall national saving rate actually understate the true problem because they include present-day saving in the social security system, which does no more than provide for the retirement of baby-boomers. These deficits exist even after several years of cuts in government spending and an absence of new spending programs. If the country should go back to its old habit of introducing new programs now and then, or if valid national needs should crop up, the saving problem will become that much worse.

The twin deficits, budget and trade, are large enough that the nation has to make fairly significant cuts to prevent the interest burden from rising as a share of total economic activity. The response of the budget summit is, to this point, unknown. At long last people representing diverse views are at least talking to each other, which is a definite plus. At the same time, the cuts are likely to be modest and barely more than Gramm-

Net National Saving and Investment

Percent of Net National Product



Rudman-Hollings would have mandated anyway. And all the cuts seem likely to be formula cuts such as freezes and delays. There has been little choosing among programs for the whole duration of the budget crisis.

So the country is now in a very vulnerable position. One can construct a scenario of modest budget cuts offset by modest easing of monetary policy and some further drop in the dollar that gradually eliminates both of the twin deficits. The ox could gradually climb out of the ditch. But the ox could also slide in deeper. Foreign lenders could stop lending, forcing investment to the low level of saving and forcing U.S. living standards down sharply. Or there could be a recession, something that is not only bad enough in its own right but also disastrous for saving, investment and the budget deficit.

Even assuming the budget summit works to get the deficit down a bit, without a recession in the meantime, a sizable fiscal problem will confront the next administration. Budget deficits are likely to be in excess of 3 percent and national saving rates no more than 3 percent, still quite low by historical standards. And all this with no obvious relief from the social security problem, the interest overhang problem, and the private saving problem. It is hard to see how things can be turned around without (1) some combination of far more stringent spending cuts on top of those already made through the budget freezes and Gramm-Rudman-Hollings mandates, (2) more extensive income-tax base broadening even after the diligent search for base-broadeners in 1986, or (3) a value added tax with a rather high rate. None of this will be pleasant.

A Slow-Growth, Relatively Low-Inflation International Scenario

Robert Hormats

All the major economies have been adversely affected by the global stock market decline. It appears, though, that the impact on the United States is somewhat greater, because a larger portion of U.S. savings is tied up in equities. Nonetheless, all Western nations are likely to suffer a weakening of their economies because of the crash. That has turned the international economic environment toward a slow-growth, relatively low-inflation scenario.

For the medium term the primary problem for government leaders is how to reduce the U.S. trade deficit without disrupting the world economy. Large trade imbalances and currency stability are incompatible. As long as U.S. trade and current account deficits remain large, there is likely to be constant downward pressure on the dollar. Monetary authorities will frequently be faced with the choice between tightening interest rates to stem the decline of the dollar or letting them fall further (to avoid excessive domestic contraction). Inevitably real domestic demand must fall. In part this will occur as a result of fiscal or monetary contraction, in part as a result of higher inflation resulting from a lower dollar, and in part as a result of lower purchasing power due to the stock market decline.

The dollar's recent fall is consistent with current agreements to introduce more "flexibility" in the Louvre accords. It should not be a major concern to the market—as long as it is kept under control. Foreign central banks had become uncomfortable with massive intervention to sustain the dollar at levels set at the Louvre. Now, with inflation less of a risk in the United States due to a lower dollar, price pressures would be less troublesome. Moreover, given concerns about a looming U.S. economic slowdown, it is undesirable for the Fed to raise interest rates to hold the dollar at overvalued levels, particularly since that would also delay reduction of the U.S. trade deficit.

The multibillion dollar global trade adjustment which must take place over the next few years will boost American manufacturing industries. Export-oriented industries in the United States and those facing heavy import competition—the sectors that were most adversely affected by the strong dollar—are now in a far more favorable competitive position. There also will be a considerable increase in foreign direct investment in the United States. This results in part from the lower dollar, but it is also due to (1) the desire of foreign companies to get closer to the vast American market, (2) concern over possible U.S. protectionism, and (3) the "customization" of production, which depends in part on proximity to customers.

America's trading partners will need to decide how to offset the inevitable fall in their real net exports to the United States. If they attempt to resist this decline by introducing trade subsidies or other protective measures, or their exporters do so by cutting profit margins, they will put more downward pressure on the dollar. And should growth in their domestic demand fail to exceed that of the United States by a substantial amount, the same will be true. So, inevitably, they will have to reconcile themselves to this export fall.

Robert Hormats

"Large trade imbalances and currency stability are incompatible."

In order to avoid a severe weakening of their GNPs due to falling net exports, America's trading partners will need to foster strong domestic demand. Low interest rates—in some cases combined with fiscal stimulus—will be required abroad. And capital-exporting nations will have an opportunity to provide incentives for their citizens to make loans allowing Third World nations to import goods that are important to their growth (perhaps through co-financing with the World Bank). This could reduce pressures on them for "quick fix" stimulus.

The Japanese already seem to have boosted domestic demand with public works programs included in a broader fiscal stimulus package. Western Europe, on the other hand, appears reluctant to take stimulative action. Whether Europe is willing to do this is dependent in part on Germany, but more broadly on whether the major European economies can forge a coordinated growth policy. To do so several European nations need to stimulate their economies together. This would prevent Germany from taking too large a share of the burden and suffering too adverse a decline in its intra-European trade balances as a result of unilateral stimulus.

The Group of Five and Group of Seven, which produced the Plaza and Louvre Accords, remains the focal point of the international policy and currency coordination process. Soon after the United States reaches a congressional-executive budget compromise these groups will likely meet to reach a consensus on the proper "holding zone" for currency rates for the next few months, and on the additional domestic policy measures required to continue the reduction in the U.S. trade deficit. To the extent both sets of actions are credible, some renewed foreign interest in U.S. securities is likely to emerge—although over the longer term downward pressures on the dollar and skepticism about the U.S. market by foreign investors is likely to persist.

As a result, over the next several quarters international growth is likely to be weaker than predicted before the market crash, and inflationary pressures will be modest. Currency instability is likely to break out from time to time. Frequent discussions among key financial and monetary officials will be required to ensure a measure of policy coordination that would combat the contractionary impact of the stock market crash and currency volatility.

A Modest Acceleration of Inflation

Joel Popkin

The stock market crash of 1987 will have a profound effect on the outlook for the U.S. economy, but not the one most analysts anticipate; its effect will be positive. The crash has led me to revise my 1988 U.S. growth estimate upward by one-half percentage point, without raising the inflation forecast. The added growth will occur in the second half of the year.

There are several reasons for the optimism. Primary among them is that, instead of drifting upward through the winter, inviting a recession, interest rates are now headed down. Why this change in the direction of Federal Reserve policy? First, higher interest rates are not needed as much to defend the dollar as they were a month ago. The spread of the U.S. stock market decline to other countries was almost instantaneous. As a result, our trading partners appear to be more inclined to coordinate their monetary and fiscal policies with us than to try to go their own ways. Such coordination would, of course, serve to stabilize the U.S. dollar.

Even if this promise of better international coordination of economic policy remains fragile, there are signs of a better coordinated U.S. economic policy. Congress and the President are acting to significantly reduce the federal deficit. Taxes on stock market gains taken in the October market decline will provide unanticipated federal revenues for fiscal year 1988. And Federal Reserve Board Chairman Alan Greenspan will deliver on the promise of his predecessor, Paul Volcker, to ease monetary policy when the federal deficit looks like it is coming down.

While the federal deficit should contract, progress on reducing the trade deficit will remain difficult to discern. The coordination of international economic policy—in this case, in stimulating economic growth among our trading partners—should prompt increased growth of U.S. exports. But there is little likelihood of reducing our reliance on other countries, particularly the newly industrializing Asian countries and other low-cost producers, to meet our demand for low-technology consumer goods.

Joel Popkin

"The crash will have a positive effect."

My forecast is that U.S. output will grow 2¾ percent from the fourth quarter of 1987 to the fourth quarter of 1988. Inflation, as measured by the consumer price index, will remain in the 4 to 4½ percent range through the middle of 1988 and accelerate to 5 to 5½ percent in the second half. That acceleration will reflect primarily the spreading effects of the record-length peace-time expansion on U.S. labor markets. This year both skilled and unskilled labor markets have tightened considerably, and real wages have declined—their first significant drop since 1980. They are the two major forces prompting wage hikes. The decline in the U.S. dollar will also add to the inflation rate.

The acceleration of wage and price increases will make the Federal Reserve Board tighten monetary policy next fall, which could produce a mild recession—but in 1989, not 1988. This recession would help answer the question of whether wages and prices will become more flexible downward when demand weakens than they were during downturns of similar magnitude and duration in the 1960s and 1970s.

The Unease of Consumers

F. Thomas Juster

The recent sharp decline in United States and world stock prices has changed a once routine discussion about the future of the United States economy, one bounded by limits of 2.5 percent expansion on the pessimistic side and 3.5 percent on the optimistic side, to a discussion of whether recent events will push the United States into recession.

The stock price decline can be expected to have two kinds of effects on the economy. There are direct effects—consumers have less wealth, as do businesses with financial portfolios, and all businesses face higher capital costs, at least in terms of equity capital. Probably more important are the indirect effects. The kind of information available to people as they envision the future has changed dramatically, and neither consumers nor business have any way to process this new information. If they can't process it and, therefore, don't know what it means, they will likely feel uneasy and uncertain. And policy responses are likely to factor into an assessment of the indirect effects. If people believe that whatever caused the sharp decline in stock prices is both understood and soon to be remedied by policymakers, they will be less uneasy and uncertain. But, if consumers feel that policymakers neither understand the problem nor are they about to fix it, the unease and uncertainty will increase.

F. Thomas Juster

"Not a very pleasant conundrum."

Direct Effects of the Decline in Stocks

Macroeconomic models often have a wealth variable in their consumption equations that shows a substantial effect on current consumption. For the U.S. economy, the effects are on the order of magnitude of 3 to 5 percentage points—that is, a one dollar change in wealth produces a 3 to 5 cent change in consumption over the course of the year. That could easily be a substantial overstatement in view of the following facts.

As of 1983, 80 percent of U.S. households owned no stock at all, and of the 20 percent who did, all but a small fraction owned very modest amounts (ranging from a couple of hundred to a couple of thousand dollars). While these proportions must have changed somewhat between 1983 and 1987, the fact that only a small fraction of U.S. households own substantial amounts of common stock is surely still a valid generalization. To sense the degree of concentration involved here, note that in 1983 80 percent of total common stock was owned by households whose net worth was over half a million dollars; 50 percent of common stock was owned by households whose income was in excess of $200,000 a year.

Although the direct effects on stock may be limited to a few wealthy households, the question arises as to the effect on the many people who own equity in a pension fund. The answer is that declines in stock prices have virtually no effect on 85 percent of the pension entitlements. Most pensions are "defined benefit" plans, in which the employee is entitled to an income stream that is a function of earnings rates and years of employment. If stock prices decline, nothing happens to the expected value of pension rights unless the decline is sharp enough to cause the pension fund to become insolvent or the firm to become bankrupt. Neither of these is at all likely, since most pension funds seem to have become overfunded during the sharp run-up in stock prices of the last several years. Thus the pension effects are limited to the 15 percent of households who do not have defined benefit plans, and those effects are unlikely to be substantial.

Indirect Effects

Here, the potential for damage seems much greater. Consumers and business executives interpret the future through a kind of mental model, in which they make judgments about whether things will go well or badly for them and for the economy. These judgments, in turn, influence their spending and investment decisions. An event like the stock market crash ruptures that mental model, and people have to begin to interpret what it means. We now have some data on how this event changed consumer expectations and attitudes, and the news is not reassuring.

The Survey Research Center at the University of Michigan conducts a monthly survey of consumer sentiment, and interviews are done continuously. In October, about two-thirds of the interviews were completed prior to the stock price decline on October 19, the remaining (roughly one-third) were done after the decline. Although the sample sizes are very small, the data show that:

- Overall, the Index of Consumer Sentiment was 92.5 before the decline and 82.4 after—a 10-point drop.
- Of the Index components, the measure of current conditions (which looks currently and backward rather than forward) fell from about 105 to 98, while the expectational component (which looks forward as much as five years) declined much more sharply—from 84 to 72.
- Judgments and expectations about current financial status were totally unaffected—the index of current compared to last

year's personal financial circumstances actually rose 4 points (from 117 to 121); the index of expected personal financial status also rose trivially (from 128 to 129).

- The other current conditions component—buying conditions for major household durables—also declined quite sharply (from 156 to 134), but continued at fairly high level by historical standards.
- But expectations about business conditions, both one year ahead and five years out, declined precipitously—the expectations for one year ahead dropped 26 points (from 113 to 87), while the five-year index fell 16 points (from 98 to 72).

We might well ask how much confidence can we place in a sample of 150 households? The response is, of course, not very much, since the sampling error is about plus or minus 5 percentage points, and thus the actual change barely exceeds two standard errors. But early November data seemed to be confirming the late-October level shown in the above tabulations, although the mix of component changes is not as sharply differentiated.

What does this imply for consumer spending over the next several quarters into 1988? The most accurate answer is that we don't know yet. Events of the sort that happened in late October have not happened before. A 10-point drop in the Index of Consumer Sentiment approximates the biggest changes recorded over the past several decades and, for the most part, those changes were recorded from one quarter to the next, rather than from one month to the next (let alone from the first part to the last part of the month). In the final analysis, one has to speculate on the basis of what seems plausible.

My guess is that this decline will have a substantial effect on consumer spending. Just how substantial depends on whether consumers perceive that policymakers are prepared to mend their ways and fix the twin deficits, or are taking a business-as-usual approach and applying a temporary fix. In particular, it depends on whether the President is prepared to accept a tax increase.

One can easily read the sharp decline in stock prices as a "no confidence" vote on current U.S. economic policy. If consumers come to share that perception, it would be bad news indeed: Historically, consumers become cautious when they feel policymakers don't know what they are doing.

What is the likely response of the policymakers? They are of course in a bind—to fix the twin deficits, one has to start by fixing the budget deficit, but in the short run that implies weakening the economy. No doubt there is some mixture of a tougher fiscal policy and an easier monetary policy that would produce neutrality. But the easier monetary policy is, at least in the short run, the weaker the dollar. Thus both fiscal and monetary policy are in a bind—to toughen fiscal policy means short-run weakness even though it might help in the long run, while to loosen monetary policy means an even weaker dollar, adverse terms-of-trade effects on the U.S. standard of living and a threat to the willingness of foreign borrowers to hold U.S. assets. It is not a pleasant conundrum but, after all, that is what we pay policymakers for. They will have a chance to earn their pay over the next year.

The Risks to Capital Spending

Stephen S. Roach

Capital spending has been one of the more pleasant surprises of 1987. Following a sharp decline in the first quarter, annualized gains in real business fixed investment averaged close to 18 percent in the second and third quarters. Over the four quarters of 1987, real capital spending is expected to increase 5¼ percent—a sharp turnaround from the 4¾ percent drop of 1986. This upturn appears all the more impressive, as it occurred against the backdrop of recently enacted tax reform measures, which reduced several key business investment incentives.

The bulk of the recent improvement has been concentrated in equipment outlays, with particularly sharp gains in information processing technology, such as computers and telecommunications equipment. While total business construction spending also rose sharply in the third quarter of this year, the gain was largely concentrated in petroleum exploration activity. By contrast, real business building outlays remain about 8 percent below their readings a year earlier.

The renewed gains in capital spending can be traced, in large part, to the gradual narrowing of the U.S. foreign trade deficit—reversing some of the pressures that produced the investment decline of 1986. The accompanying chart, which is based on the quarterly plant and equipment survey of the Department of Commerce, shows that the major shifts in 1987 business spending budgets have been concentrated in the industrial-materials and capital-goods producing segments of the economy. These are the same industries that have benefitted most from a sharp revival of export demand. In contrast, other industries have changed their spending plans very little over the past two years.

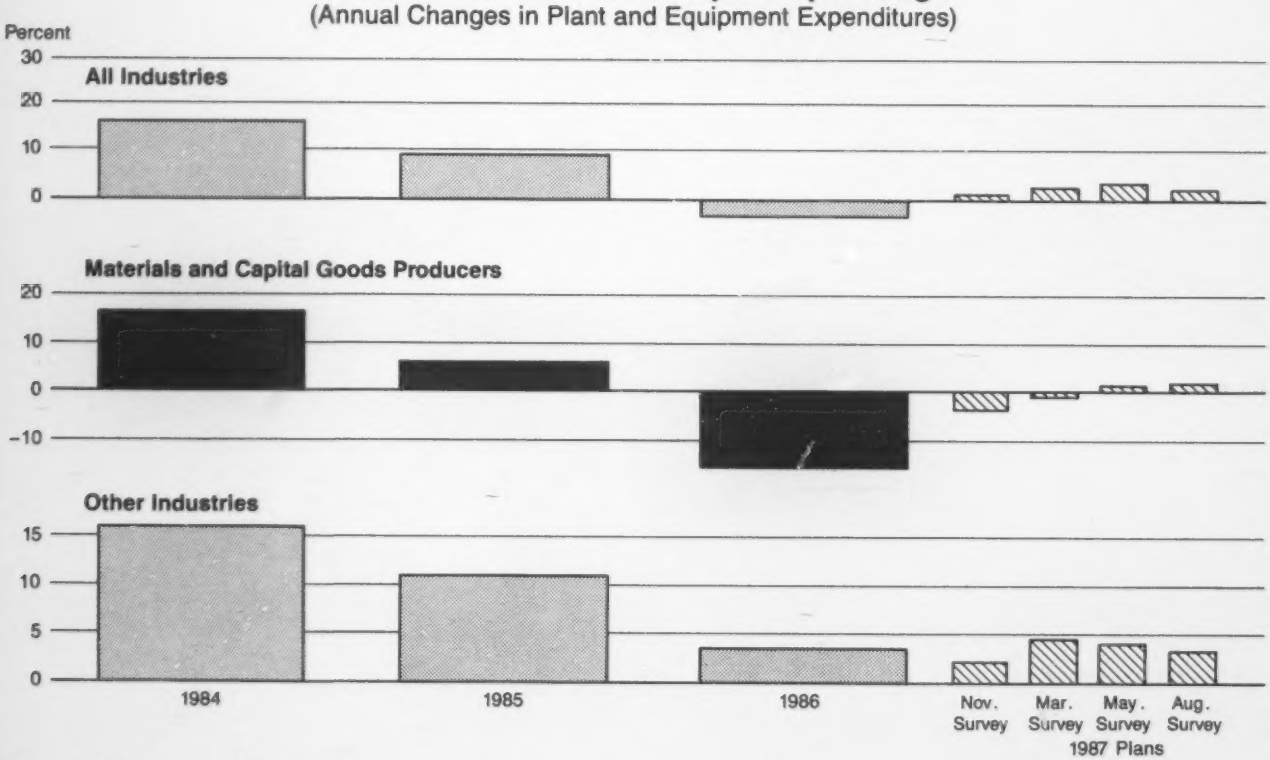
Stephen S. Roach

"The capital spending bet is more and more a long shot."

The foreign trade "kick" to capital spending stems largely

The Turn in Business Capital Spending

(Annual Changes in Plant and Equipment Expenditures)



Source: U.S. Department of Commerce.

from the fact that surging export volumes have prompted a boost in production that is large enough to begin putting strains on existing capacity. For example, primary processing industries—mainly industrial material producers—were operating at 85.2 percent of rated capacity in September; that is almost 4 percentage points above the reading a year earlier. Since higher capacity utilization rates reflect intensified pressures on existing facilities, businesses typically respond by gearing up expansion plans. Such adjustments are what lie behind the upwardly-revised capital spending programs of export-sensitive industries.

Despite the recent improvement in capital spending, some disquieting signs have emerged in recent months. New orders for nondefense capital goods—a key barometer of prospective trends in business equipment pruchases—have been essentially unchanged over the July to September interval. To be sure, such stagnation follows relatively sharp increases over the first half of this year and, thus, would not normally be cause for alarm. But then along came the Crash of 1987, and in that context a softening of orders could turn out to be a far more disconcerting development.

In the aftermath of October 19, the capital spending outlook suddenly seems clouded with uncertainty. Of key significance would be any unexpected shortfalls in consumer demand that would prompt production adjustments and lower capacity-utilization rates. Since some downshift in consumer spending appears to be an inevitable consequence of the stock market's contraction, it would hardly be surprising to see Corporate America begin paring its capital spending plans. As the Crash occurred when year-end budgeting decisions were being finalized, the possibility is all the more likely. In addition, lower stock prices translate into higher capital costs for U.S. business—another consideration that could retard capital formation. Although the improvement in the bond market is partly offsetting this handicap, historically low levels of equity-to-debt ratios suggest this will be of limited assistance.

On the positive side, support still seems likely from the petroleum and export-producing industries. This year's higher level of world oil prices virtually assures further increases in drilling—the driving force behind the petroleum industry's capital spending budgets. And barring a collapse in global demand, U.S. exporters should continue to win back market shares lost during the early half of the present decade—especially in light of recent declines in the value of the dollar in foreign exchange markets. Such trends augur for relatively firm operating rates in the export sector—prompting additional capacity expansion in these industries.

But the Crash is the wild card. With the risk of recession now higher than at any point in the past five years, the capital spending bet is starting to look more and more like a long shot. As the dust of October 19 settles on the economic landscape, the business spending climate will find itself in an increasing state of flux. The old adage, "Time will tell," is more appropriate than ever at this juncture.

Stretching the Expansion

Francis H. Schott

Declining interest rates may help to stretch the current U.S. expansion through 1988, but optimism must be tempered by concerns over consumer psychology, the federal budget outlook, and the achievement of international economic policy coordination.

Before the stock market crash of October 19, 1987, there was legitimate concern that monetary and exchange-rate policy might short-circuit an aging but still-moving expansion. In defending a dollar rendered increasingly vulnerable by continued heavy trade deficits, the Federal Reserve and the credit markets appeared to be going "beyond the call of duty" to contend with the normally growing inflation concerns in a late expansion. The last (aborted) upward push in the prime rate to 9¾ percent in the week preceding October 19 would have raised that rate by 2¼ percentage points in a single year. During that same year, ended October 1987, the 30-year Treasury bond yield rose even more, from 7½ percent to nearly 10½ percent. Money market rates, which had been carefully managed by the Fed to rise by only a percentage point between October 1986 and August 1987, suddenly escalated by another full point in the two months ending with the stock market crash.

Amid other factors contributing to the plunge of equities, those interest rate developments should not be forgotten. By September, consensus opinion among business economists was already that the next recession would occur in 1988 or 1989, with most leaning toward 1989. But an earlier recession appeared more and more likely as rates escalated. The housing market in particular became a question mark as fixed mortgage rates rose to 11½ percent. Corporate profit forecasts were beginning to be downgraded, and fixed-rate instruments were competitively gaining on equities.

In this light, October 19 and its aftermath may be a blessing—a well-disguised one, to be sure. Interest rates have given back roughly half of the preceding year's increase, with the prime rate at 8¾ percent, the 30-year U.S. Government bond under 9 percent and the 3-month Treasury bill at 5¾ percent. Mortgage rates are also responding. Quality spreads have widened—the high-yield bond premium over corresponding Treasuries is at about 4½ percentage points against 3 points previously, but uncertainties surrounding the junk bond market naturally heighten at times like this.

Francis H. Schott

"Interest rates will cease declining by early 1988."

Taken by itself, the interest rate decline will help to stretch the expansion, especially because corresponding action abroad may stimulate the economies of other leading industrial nations. The fact that the dollar is depreciating is an additional stimulus in the United States.

These positive effects must of course be weighed against the wealth-reducing effects of the stock market decline and attendant consumer apprehensions. In particular, major policy concerns include a credible federal-budget-deficit reduction, which is necessary to reduce the need for capital inflows, to help the Fed in maintaining an accommodative stance and, above all, to encourage foreign cooperation in lowering interest rates worldwide.

On balance, I believe the economy will withstand the strains and continue to move up at about a 2 percent annual rate. This also implies, however, that the Fed will gradually revert to its basic anti-inflationary stance so that interest rates will cease declining by early 1988. By mid-1988, interest rates may again be moving upward, but without reaching pre-October 19 levels. Inflationary pressure caused by the depreciating dollar will play a major role in Federal Reserve policy. A moderate recession in 1989 then becomes more likely, but meanwhile another year of growth will have been achieved, and the recession would be just that—a recession, not a depression.

The Crash of 1987

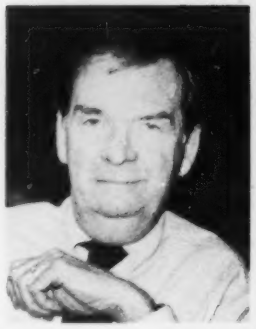
Robert G. Wade, Jr.

The stock market crash of 1987 occupies the thoughts and conversation of virtually everyone associated with financial markets and most of the rest of the world. And it will be a focal point for historians for years to come. For those of us immersed in the shock and its aftermath, it is still too early to make definitive judgments about the implications of the crash. However, as investors we must make decisions and begin the process of analyzing risks and opportunities.

Everyone has a favorite list of causes of the collapse. Overvaluation of equities has now become apparent although, predictably, that is far clearer in retrospect than before the fact. Interest rates, both short and long, had risen sharply in the United States and around the world. The weakening dollar was creating increasing anxiety, particularly among overseas investors. A paramount cause of this was the U.S. budget and trade deficits and a growing concern that the country has a terminal case of overconsumption. This leads to the impression that there is no effective leadership in Washington, with a lame-duck president injured by recent events (Iran, Bork, personal problems) and a Congress preoccupied with partisan issues and the 1988 elections. Finally, any roundup of the usual suspects must include portfolio insurance and program trading, which are not widely understood but are increasingly viewed as exaggerating market moves in both directions.

So much for the causes. What should we expect now? In the strictly near-term, the good news is that from a technical standpoint, under most scenarios, stock prices should work somewhat higher. Whether one thinks we are experiencing a rerun of 1929, or virtually any other historic market break, the past shows that prices tend to retrace at least 50 percent of their decline. This at least provides time to sort out some of the other critical variables.

Chief among these variables is the possibility of recession. If, as a result of the crash and its "wealth effect," the economy goes into recession in 1988, today's stock prices are vulnerable. However, we don't believe this to be the case. We acknowledge that there should be some effect on spending and confidence, but not enough to offset what we believe will be efforts by the Federal Reserve to keep the recovery going. Given the present momentum of corporate earnings, we are estimating real GNP growth for 1988 at 2 percent, while inflation remains in the 4 percent range.



Robert G. Wade, Jr.

"On the twin deficits, what is desired is progress, not a total solution."

We believe it possible that the sudden collapse of markets around the world will lead to greater cooperation among our major trading partners. Such cooperation is contingent upon the perception that Washington is prepared to take steps to deal with the twin deficits, particularly the budget. What is desired is progress, not a total solution. Indeed, too great a cut in spending and too big an increase in taxes would create fears of the medicine producing a recession. More of a reduction of the deficit than would occur under Gramm-Rudman and a commitment to at least a second year of cuts would represent such progress.

As mentioned earlier, it is still too early to have strong convictions about the future course of the market, but there is time to sort out the evidence. Our best guess at the moment is that there is a good chance that conditions will permit a positive stock market over the next six to twelve months.

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The Conference Board

Economic Outlook 1988-89

Fourteen prominent forecasters see:

- *sturdy, but not spectacular, U.S. growth*
- *modest flare-up of inflation*
- *risk of "hard landing" for bond markets*
- *rising economic activity worldwide*
- *near boom in capital goods*

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May 4, 1988

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Crowding the Limits of Capacity

Edgar R. Fiedler

In their Spring review of the business outlook, members of the Economic Forum reached a clear consensus on forecasts that contain a mixed bag of cheer and melancholy. The first of these forecasts, one of the more encouraging, is that the world economy will continue to expand through the remainder of 1988 and on into next year. Although the pace of advance differs moderately from one projection to another, the expectation of rising economic activity was universal among the group and for every nation discussed.

The most powerful force behind this continuing business-cycle advance is the capital goods sector, which is registering near-boom conditions in virtually every part of the industrial world. In the United States the expansion is also being driven by improvement on the international trade front, with domestic producers gaining from both rising export demand and the displacement of foreign producers from local markets. In nominal terms the trade deficit has narrowed only slightly, but in physical-volume terms the export-import balance has moved significantly in favor of U.S. manufacturers.

Edgar R. Fiedler

"We have the building blocks of bond-market nightmares."

Consumer spending and other sectors of the American economy are moving less powerfully than capital goods and exports, but most remain on the upgrade. More inventory building is in store, for example, in part because the longer production process makes capital goods an inventory-intensive activity. The only genuinely weak market is multifamily and commercial construction, where high vacancy rates are severely suppressing demand.

Pulling all the strands together, the U.S. economic outlook for 1988 adds up to unspectacular but sturdy growth of about 2½ percent. Furthermore, the absence of significant cyclical excesses in such areas as inventories and consumer durables means that this forecast faces a less-than-usual risk of being far off target. Nor, for awhile at least, is there any reason to expect the expansion to be hindered by a lack of available credit.

The economic upswing has generated several indications of inflationary pressures—in the prices of metals and certain other materials, for example. To this point, however, evidence of inflationary trouble has not become general. The broad indexes, such as the consumer price index, continue to show about 4 percent inflation in the United States and 0 to 4 percent abroad. Furthermore, there are no persuasive signs of accelerating inflation on the wage side either.

It is *not* time to bury the Phillips Curve, however. The economy is clearly crowding the limits of capacity, the point where inflation begins to accelerate. With unemployment below 5½ percent of the labor force, the economy is well into the zone

The Forum Consensus
Results of a Pre-Meeting Outlook Survey

	Actual	Projected			
		1988		1989	
	1987	Median	Range	Median	Range
	(%)	(%)	(%)	(%)	(%)
Economic growth (change in real GNP)	4.0	2.5	1.0 - 2.6	1.5	0.1 - 2.5
Inflation rate (change in GNP deflator)	4.3	4.5	3.2 - 5.2	4.7	3.9 - 6.0
Corporate Profits (with IVA & CCA) (change before taxes)	11.3	10.0	0 - 14.0	5.0	-6.0 - 10.0
Unemployment rate (average during final quarter)	5.6	5.5	5.2 - 6.2	5.7	5.0 - 6.2
Commercial bank prime rate (average during final quarter)	8.6	9.25	8.5 - 10.0	9.0	7.5 - 10.0
Federal Budget Deficit (billions of dollars; based on fiscal year)	150	160	140 - 175	170	130 - 195

Note: These forecasts incorporate submissions by Forum participants in early May, and are based on data available at that time. For growth, inflation and profits, the annual forecast is the percentage change over the four quarters of the year, i.e., from 1987 IV to 1988 IV.

of "full employment." Operating rates in manufacturing show almost the same degree of congestion. In several cases, such as paper and chemicals, capacity utilization is at shortage levels. Other industries are approaching this degree of tightness. Inevitably, these pressures will trigger a flare-up of the inflationary embers. Thus far, the price-wage outlook is not explosive, since major accelerations usually develop gradually rather than abruptly. But most Forum members anticipate a modest step-up in the inflation rate during the second half of this year.

"For our paper anniversary, he's going to assume my share of the national debt."

Drawing by Geo. Price; © 1988 The New Yorker Magazine, Inc.

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Budget deficit. The federal budget was the one topic that generated real controversy among Forum participants. For the near-term, almost everyone anticipates the deficit creeping up gradually, from $150 billion last year, to $160 billion in 1988 to $170 billion next year. The discussion was more heated concerning the outlook for the next four years or so. Those taking the optimistic side of the argument note that federal spending has been nearly flat in real terms since 1985, and claim that a continuation of this trend coupled with modest revenue growth will reduce the deficit to less than 1 percent of GNP by fiscal 1993. Consequently, the optimists suggest that the new National Economic Commission, which is charged with funding a consensus on how to reduce the deficit, should declare victory and go home, since neither further restraint on spending nor a tax increase is required to achieve a satisfactory budget outcome.

The pessimists do not accept this argument, of course. They say that, with or without higher taxes, Congress is not going to hold spending to the modest trend of the past two years. They believe pressures for major spending increases—for such programs as long-term home care for the elderly—will prevail. Thus, the deficit will remain extraordinarily large—much larger than is consistent with the volume of capital formation needed to stimulate long-term economic growth.

The group also discussed the stark dichotomy emerging between the *two* federal budgets—the social security trust fund, which is starting to generate dramatically large surpluses, and all other federal accounts, which together will continue to register massive deficits. Under present law the two budgets will no longer be combined into one and, at the least, the sharp contrast between them will generate serious public controversy about the fairness of using a regressive payroll tax system to finance general federal spending.

Interestingly, Forum participants hardly mentioned the forthcoming presidential election. This is due, perhaps, to the expected tedious nature of the coming campaign. Rather than advocating basic policy reversals the leading candidates are dwelling on "managing the government better." Thus, paraphrasing comedian Mark Russell, the campaign may turn out to be a case of "the bland leading the bland."

Financial impact. The continued strength of business combined with mounting inflationary pressures and massive deficits have given the financial markets reason to be nervous. In addition, the markets will not quietly accept major international imbalances that are not being rectified decisively. All of these are the building blocks of bond-market nightmares.

Once the Federal Reserve sees unmistakable evidence of accelerating inflation, it will have no choice but to tighten policy, and if it does not move quickly enough (and economic activity does in fact quicken) the market will then do the Fed's work for it. Thus far, however, the Fed evidently does not find the evidence of prospective overheating as persuasive as most Forum members. But the lesson of the 1960s and 1970s is that the time to stop inflation is early, preferably before it really gets started. Once under way, inflation picks up a great deal of momentum and is extremely difficult to turn around. Accordingly, some of us believe the Fed should be tightening policy now. (One Forum member asked: "What are they waiting for?" Another responded drolly: "The election maybe?")

As usual, the monetary authorities prefer to move in small increments. But this is not always possible. Relative to the volume of trading, the financial markets lack depth, breadth, and resiliency, which means that when interest rates move they sometimes move very abruptly. Accordingly, the risk of a "hard landing" in the fixed-income markets seems all too large.

But while the outlook for the bond market has turned sour, the Forum's specialist on equities, Michael Sherman, is less concerned. He agrees with the rest of the group about the hazards that are present, but he believes that many of these worries are already being taken into account by the stock market. Clearly there is fear in the market of another Great Depression. There is fear of overheating. And there is fear of the computers—that is, of the hazards of programmed trading. Given these apprehensions, many investors have already withdrawn from the market and are sitting on large reserves of cash. Accordingly, he believes the stock market has discounted, to a substantial extent, the dark financial clouds perceived by the Forum. Unless the environment deteriorates further, then, his guess is that equity prices will go up, not down, over the remainder of 1988.

And what about the economic outlook for the second half of 1989? In view of the continued cyclical strength anticipated for the rest of this year and the probability that already high real interest rates will go still higher, the U.S. economy will become increasingly vulnerable to recession as 1989 progresses. On the other hand, the major driving forces in 1988—capital spending and the depressed dollar—could easily prove to have enough staying power to carry the economic expansion through all of next year. Accordingly, until and unless some new cyclical force enters the picture, Forum members will remain emphatically indecisive about prospects for late 1989.

The Narrowing Economic Road

Albert T. Sommers

In 1988, the U.S. economy is traveling a narrowing road, high up on its cyclical course. In the second quarter, it appears to be much nearer the expansion-inflation side of the road than it is to the recession-deflation side.

After more than five years of growth, the economy still shows little or no indication, within its non-financial structure, of the usual harbingers of recession. Orders are generally strong; backlogs are rising (although recent elevations of backlogs have been primarily in the aircraft and other transportation equipment industries); inventories appear to be under very satisfactory control (see below); and the capital goods market is growing, with as yet no indications of any enthusiastic excesses.

Almost all of the sectors of demand appear to be in strong but not dangerously euphoric condition. Buttressed by very satisfactory attitudes, and perhaps also by recent tax reduction, personal spending is growing moderately; exports are continuing to grow in both dollar and real terms; capital spending (apparently now even for structures) is growing at a real rate of perhaps 6 percent. Outlays by the federal government are about stable (perhaps even declining a little in real terms), and multi-family housing is depressed; the nonmanufacturing parts of nonresidential construction (retail facilities, office buildings) are also subsiding. But the total balance among sectors is almost unequivocally strong—The Conference Board index of cyclical phase, which measures the degree of cyclicality in the composition of aggregate economic activity, is still broadly indicative of growth.

An extra word or two about the inventory condition is doubtless in order. In the first quarter of 1988, the Department of Commerce recorded a much higher figure for inventory accumulation than appeared likely from the available monthly figures. Some of this excess reflects farm inventories (which in turn reflect low purchase activity by the Commodity Credit Corporation, a condition also reflected in the sharp decline of government purchases). The Commerce Department figure assumes strong growth of inventory in March, but this has not been borne out by the monthly book-value figures just released. In any event, attitudes toward inventory remain firm and positive, perhaps somewhat accentuated by the high rate of price increase that now prevails among the materials and components inventories held by the industrial sector. Aggregate inventory demand will probably subside for two quarters now, simply because the rate is high; but there is little or nothing in the way of unintended inventory accumulation that would have cyclical significance.

Albert T. Sommers

"The expansion will enter treacherous terrain."

The somewhat dependable trend of expansion has appeared when resource availabilities for both labor and capacity are more limited than at any time in the decade. Very little is known

about the idle supplies of labor and equipment available for engagement, but it is reasonable to assume they are of considerably lower quality than the average now engaged, a condition that suggests upward pressure on the price level. This condition is confirmed by reports from purchasing agents and, increasingly, from direct evidence on prices and wages. With respect to wages, the evidence is equivocal, but clear enough to show that the long decline in wage inflation is over and that a modest increase is beginning to appear.

The fundamental issue facing forecasters lies not in interpreting the conventional cyclical evidence, but in appraising the consequences of cyclical growth starting from such a high level, all in the presence of a strong export market and a still-large budget deficit, still being financed accommodatively by inflows of capital from abroad. This formulation obviously transfers the focus of forecasting from the real world, where life is, if anything, too good, to the financial world. It is widely, and quite correctly, believed that real-world conditions now carry significant implications for inflation, and all of the statistical and verbal evidence suggests that the Federal Reserve sees the issue in precisely that way. An orderly decline of inventory demand over the next several months can defer this issue for a time; but implicit in the structure is a persistent upward tendency in interest rates, perhaps accelerating as growth presses harder on resources, and as participants in the bond market, already very alert to the issues, accentuate behavior that anticipates (and therefore produces) still higher rates.

By late in 1988 and early 1989, the expansion imaged for the U.S. economy by trends visible in the real world is likely to enter treacherous terrain featuring higher inflation, higher short-term interest rates, a deteriorating bond market, and at least moderate upward pressure on labor costs, even on unit labor costs. The Fed has conducted itself admirably in its efforts to delay such a cyclical climax, but its powers are limited, particularly in light of the sophisticated anticipatory capacities of the bond market. For the first time in many years, it is possible to view, less than a year ahead, a cyclical climax and genuine recession. Such an outcome is now incorporated in The Conference Board model, with the U.S. growth rate falling very sharply beginning in the Spring of 1989 and yielding negative growth in the last half of the year.

Even 1989 is not really a disaster given such a scenario, but its growth rate is likely to be only half that of 1988, and operating profits, after a strong advance in 1988, are likely to be little changed in 1989. The fundamental issue posed by this trajectory is how the system escapes from the immense budget and trade deficits imposed upon the system by the rather undisciplined "supply-side" policy structure of the past several years.

The *Nice* Challenge

Richard P. Nathan

This year, one major political and policy issue is what *The New York Times* recently referred to as the "crisis of trillions." This is the projected build-up of very large surpluses in the Social Security program due to the legislation passed five years ago based on the report of the blue-ribbon Greenspan Commission. In an insightful *Times*' article, "New Issue on Budget Horizon: What to do about Surpluses," Peter T. Kilborn discussed the challenge posed by the unanticipated effects of the 1983 legislation intended to make the Social Security system solvent when the baby boom generation comes of age.

Richard P. Nathan

"An opportunity to stimulate investment."

The questions this issue raises for economic and fiscal policy are now before the National Economic Commission chaired by Drew Lewis and Robert Strauss. These projected surpluses are almost scary good news; those built up in the peak years could be larger than the total national debt, and the annual surplus could be four or five times current federal deficits, depending on whose estimates you accept.

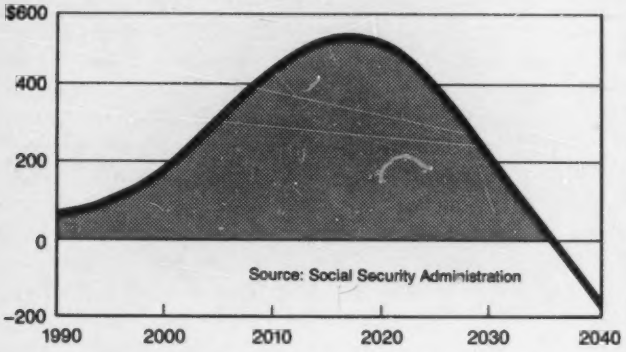
The temptation for the political process is to use these Social Security funds—to buy now and somehow pay later when the big bills become due. Then, the cohort of workers, our grandchildren in many cases, will be relatively much smaller than in the years of the *postwar* baby boom bulge.

One way to approach this *nice* problem is to go back in time to the old concept of separate budgets: a general fund (once called the administrative budget) and trust funds (like the Social Security Trust Fund) kept apart from the general fund. In 1969, the United States adopted the unified budget based on the reasoning that it is needed to gauge the total effect of the government's actions in the economy. Even if this was the right decision then—and I think it was—one could argue that it is not the right approach now.

If we once again split off the Social Security Trust Fund, we would have a better perspective on the "crisis of trillions."

The Social Security Surplus

Projected annual surpluses of tax receipts over benefit payments in billions of current dollars for calendar years.



Source: **New York Times**, April 2, 1988

But this does not solve the problem of what to do with these funds if they are "saved" for future generations in order to avoid extraordinarily high tax rates on workers in the 21st century. It does not mean that we can then isolate the so-called general fund of the federal government and treat its balance as if it were unaffected by the Social Security account.

If we posit, as many experts do, that this *problem* should be treated as an opportunity to stimulate investment, then we need to think now about how to do this. First, the U.S. could devote part of the Social Security trust fund to purchasing U.S. Treasury issues on the assumption that the Federal Reserve would adopt monetary policies enabling these funds to be channeled into investment in the nation's capital plant. Second, to the extent that buying U.S. Treasuries would not be sufficient in some years, the U.S. could also set up an "Endowment Fund" (like a pension or a University endowment) to fund carefully defined private investments in plant and equipment.

The final portion of this three-pronged approach to the new fiscal policy challenge should be devoted to investments in *human capital*: in education, training, and early child care programs, with a special emphasis on the problems of the poor in inner cities and in declining rural areas. These investments should be made under carefully prescribed conditions on the assumption that the resulting productivity increases will generate the funds needed to ensure a highly skilled labor force in the 21st century—particularly as the demands on this relatively small labor force will be very great. Perhaps 15 percent of the annual increase in the Social Security Trust Fund could be earmarked for such purposes.

Even with such a three-pronged approach, there are major issues remaining, involving (1) monetary, fiscal, and educational policy; (2) coordination with the Federal Reserve; (3) the impact of these accounts on the general fund budget; and (4) government organization and policy implementation. Should the general fund be balanced, or close to balanced, if the accounts are separated in this way? Should the U.S. consider raising taxes (if necessary) to finance general-fund expenditures? I invite my colleagues at this conference and the readers of our report to think about these important issues.

Yen's Appreciation Strengthens Regional Integration in Asia

Nobumitsu Kagami

Although the pace of world economic growth decelerated somewhat in the first half of 1988 from the unexpectedly robust expansion in the second half of last year, the underlying trend still appears to be firmly upward. In fact, there are many signs that suggest we are already in the midst of a synchronized world economic upswing led by renewed vigor in capital spending in most major countries.

The stock market crash of October 1987 exposed the world financial system's vulnerability, which has increased as a result of persistently wide payments imbalances, but the crash's impact on the real side of the world economy was much less severe than feared. At the same time, large-scale depreciation of the U.S. dollar over the past few years is beginning to have the intended effect of re-orientating industrial structures and trade flows on a global scale, although the correction of nominal payments imbalances is taking much longer to materialize than expected.

The only wild card in this otherwise sanguine assessment of the current world economic picture is the failure of the United States to redress its wide imbalance between savings and investment. Progress in redeploying its resources for the restoration of the external balance has been painfully slow. As capital spending recovers with the opening of new investment opportunities created by the dollar's depreciation, U.S. financial markets will become so strained as to cause sharp increases in interest rates, and this may lead to another financial crunch of the sort that preceded last October's crash.

While the fear of another financial crisis and a resurgence of inflation overhangs the U.S. economic scene, the outlook for the Japanese economy has brightened considerably. Real GNP grew at an annual rate of 5.9 percent in the second half of last year led by an upsurge of domestic demand. Housing and public-works expenditures provided the initial thrust to the current upturn. Consumer spending, especially on big-

ticket consumer durables, followed suit. Apparently, the Japanese consumer now feels much more confident and richer as a result of the prolonged boom in the Japanese stock and property markets. Compared with this, the impact of last October's stock market demise was negligible.

Nobumitsu Kagami

"The outlook for Japan has brightened considerably."

As the current Japanese economic upswing gathers momentum, capital spending is beginning to surge. Industrial production stands 11 percent higher than at this time last year. The capacity utilization rate has reached its highest level in the past ten years. Corporate profits are booming thanks to expanding domestic demand, surging labor productivity, and reduced input prices. These favorable factors are proving more than enough to offset the negative impact on export profit margins from the yen's continuing appreciation.

All in all, Japan's real GNP is estimated to have grown 4.5 percent in fiscal 1987, ended last March, with domestic demand growing close to 6 percent. As imports surged ahead, net exports made a negative contribution of 1.1 percentage points to this overall growth. For fiscal year 1988, the picture is more or less the same. GNP growth will be between 4 percent and 5 percent with domestic demand rising again by nearly 6 percent. The engine of domestic demand growth will shift, however, from housing and public works to capital investment, while consumer spending will continue to support overall growth.

Throughout fiscal 1987, both fiscal and monetary policies were highly expansionary. The fiscal measures announced in May contributed 1.5 percentage points to GNP growth and the money supply was allowed to expand at double-digit rates, far in excess of what the Bank of Japan considers acceptable with respect to keeping inflation under control. However, in fiscal 1988 I would expect the thrust of policies, both on the fiscal and monetary fronts, to turn from expansionary to neutral, since there is already enough momentum to sustain the robust growth, which is showing every sign of accelerating.

Exports grew by 0.7 percent and imports by 12.6 percent in volume terms in fiscal 1987. In spite of this, Japan's current surplus remained large at $84.5 billion, down $10 billion from the previous year. The narrowing of Japan's external surplus will continue to be frustratingly slow in fiscal 1988, with the surplus expected to fall by $7 billion to $78 billion.

Nominal trade figures are, however, somewhat misleading, masking some important developments that are occurring largely in response to the yen's sharp appreciation. Of particular importance are rapid increases in imports of finished and semi-finished products, which rose by 33 percent in fiscal 1987 alone. The composition of imports has changed, with finished and semi-finished products now accounting for nearly half of total imports compared with about a quarter a few years ago.

As might have been expected, the major beneficiaries of expanding Japanese import markets have been the newly industrializing countries (NICs) of Asia, namely South Korea, Taiwan, Hong Kong, and Singapore. In 1987, total imports from these NICs rose by 46 percent; finished goods imports were up 60 percent and imports of machinery by as much as 67 percent. Imports from other countries in the region, particularly from the members of the ASEAN group, are also growing strongly. At the same time, an increasing proportion of Japan's foreign direct investment in manufacturing is being directed toward the countries in this region. In the period since early 1985, when the yen began to appreciate, the Asian NICs have accounted for nearly 30 percent of such investments abroad.

The recent growth of intra-regional trade in Asia has been most impressive, with emphasis on horizontal specialization rather than on a pattern of vertical trade, which characterized the historical relationships within the region. It may well be that one of the most important consequences of the latest round of yen appreciation is to strengthen regional integration in Asia through dynamic interactions between trade and investments, with Japanese companies acting as a catalyst for change.

The View From the United Kingdom

T. M. Rybczynski

The U.K. economy is now entering the eighth year of a cyclical upswing that started early in 1981. Apart from being the longest since World War I, the present recovery has also been the strongest in the last fifty years—with an average rate of advance of 3 percent per year. In addition to the exceptional length and strength, the upswing has been characterized by six basic features that are important to consider when one looks ahead.

First, the recovery has been propelled for virtually all its length by a rise in domestic demand. Apart from 1981 and 1985, when net exports contributed ½ percentage points and ¾ percentage points, respectively, to GNP growth, the additions to demand have come from home spending. Second, a rapid increase in domestic consumption expenditure was the most important element in the growth of domestic demand. Since 1981, domestic consumption rose on average by about 3½ percent per year, which is ½ percent higher than the growth in total output. The third feature behind the growth in consumer spending has been the continuing and large decline in the personal savings ratio. In 1980, the personal savings ratio stood at 15 percent compared to the last quarter of 1987 when it stood at 4.3 percent, which is below that of the United States and the lowest U.K. level since 1959.

The fourth feature of the upswing is the deceleration in prices. Retail prices, which were rising at 18 percent per year in 1986, decelerated in the last quarter of 1987 to a 3.2 percent rate. However, the decline has now come to an end and gently upward pressures have appeared. The fifth feature is the unusually strong improvement in productivity. Taking the U.K. economy as a whole, productivity per employee has increased since the beginning of the upswing at 2¼ percent per year. Productivity per worker hour in the manufacturing sector—which covers tradeable goods—has risen at the extraordinary rate of over 4 percent.

Finally, until 1986 the cyclical upswing was accompanied by a large, though declining, current account surplus. In the six years ending in 1986, on an accumulative basis, that surplus was £ 21.6 billion. As a result, the British net overseas asset position at the end of 1986 is estimated to have been £ 115.0 billion. Again, since 1986, the current account deficit has started increasing and is expected to continue to do so.

The U.K's satisfactory economic progress has been helped by three factors, two entirely outside U.K. control and the third reflecting to a large extent the thrust of economic policy. Outside the U.K's control were (1) the cyclical upswing in other industrial countries and the rapid growth of international trade, and (2) the beneficial impact of increasing oil production in the United Kingdom and of oil's very high world price until 1985.

As far as economic policy is concerned, its three main features have been a strong anti-inflationary stance, structural reforms in labor relations, and privatization. The anti-inflation policy, initially emphasizing deceleration in money supply, was accompanied by a reduction in the absolute size of government spending and a sharp decline in the absolute and relative size of public sector borrowing requirements. A marked deceleration in money supply in the first three years of the upswing was followed by the virtual abandonment of monetary targets in the last few years and the adoption of undisclosed and variable exchange rate targets, associated with a sizable depreciation of sterling (in real terms) in 1982 and 1983 (amounting to some 10 percent) and a modest one, of some 5 percent, in 1986. Public spending has been contained in relative terms and is now reduced. The public sector borrowing requirement also has been reduced and indeed turned in the present fiscal year into a net repayment of debt of about 1 percent of GNP, compared with a deficit of about 5½ percent in fiscal 1980-81. In conventional terms, the policy mix consisted of a contractionary fiscal element, an expansionary monetary element and, until recently, an expansionary exchange-rate element.

T.M. Rybczynski

"In 1988, strong growth in the U.K., with limited deceleration."

The reforms of labor legislation have resulted in a dramatic decline in strikes and the removal of restrictive practices, still spreading, with a beneficial impact on productivity. Finally, the privatization embarked upon in 1985 introduced a new dimension into the economic climate, which also changed the economic structure. Privatization is helping to stimulate competition outside the utility areas, and is causing industrial management to adopt entirely new and forward-looking strategies.

In retrospect, the United Kingdom has pursued a supply-side policy helped by an easy monetary policy and, until recently, a supportive exchange-rate policy. The result was an essentially consumption-led upswing accompanied by a decline in the current account surplus which has now moved into deficit, and by gently upward pressures on prices. One important feature of the present upswing is that, excluding a slow-down in 1984 due almost entirely to the coal strike and excluding also a modest deceleration in the second and third quarters of 1985, the pace of expansion (year on year) has been

gathering momentum. Indeed, in the second half of 1987 the rate of growth reached nearly 5 percent with the non-oil economy growing around 6 percent per year. Preliminary estimates suggest that this pace continued in the first quarter of 1988.

In the absence of external financial or real shocks, growth is expected to decelerate somewhat in 1988; it will slow down more next year. Compared with 4½ percent in 1987, the official estimate of a 3 percent advance in 1988 is certainly too low. A 4 percent rise made up of a 4½-5 percent advance in the first half of the year and of around 3 percent in the second half is more likely. This is so because of (1) the buoyancy of consumer spending, which expanded at 6 percent in the first quarter of 1988 and is likely to be reinforced in the months ahead by lower interest rates, tax concessions, and lower import prices; (2) the strength of total investment spending, which is planned to increase in 1988 by 11½ percent; and, finally, (3) the likelihood that stock-building and government expenditure will also be higher. The industrial survey, falling unemployment, higher vacancies, and high confidence all confirm this.

In 1989, there will be further slowing down. Official estimates put the rate of advance in the first half of 1989 at around 2½ percent, compared with 2¼ percent (year on year) in the second half of 1988. This is due to a slowing down in consumer spending, fixed investment, and net exports. The question is whether the pace of deceleration will be faster or slower due to changes in government policy. Because of its relatively satisfactory performance, net creditor position and relatively high interest rates, the United Kingdom has been attracting a large inflow of foreign capital, far in excess of that needed to finance the increasing external deficit. As a result sterling has been subject to strong upward pressures. Until February the authorities pegged exchange rates by apparently sterilized intervention, but sterling is now being permitted to rise.

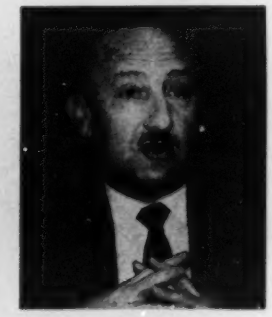
If this policy is maintained or indeed combined with one of sterilized intervention—which would increase interest rates—the momentum of expansion would probably be affected adversely. This would reflect the deterioration in the competitive position of the tradeable-goods sector and/or the effect of higher interest rates on investment and consumer spending. If a policy of unsterilized intervention is resorted to, the likely inflationary consequences will also tend to push interest rates higher.

Thus it appears that the slowing down will be faster in 1989 than officials currently anticipate, that inflationary pressures will probably be stronger and the balance of payments deficit somewhat higher. Inasmuch as the U.K. upswing has been driven by consumption supported by easy monetary policy, growth in consumer debt, and worsening external accounts, it resembles that of the United States. However, as the United Kingdom is a sizable creditor and has a public sector surplus, its position and problems are different.

The Economic Outlook in France

Albert Merlin

Before looking at the French economy itself, we must first speak about the international context. The world economic situation today features exceptionally rapid and quite unexpected growth. No matter which way you measure it, the conclusion is the same: Growth is strong. The surge in world trade since mid-1987, the boom in automotive production in most countries, the dramatic pick-up in world steel production, which rose by 15 percent in a year, and the recovery in nonferrous metal prices all confirm the strength of present growth.



Albert Merlin

"The competitive position and profit margins of French firms are excellent."

What's more, inflation is staying down to somewhere between 2 percent and 4 percent in most countries. This is a highly favorable factor, even though there has recently been some nervousness about renewed inflation.

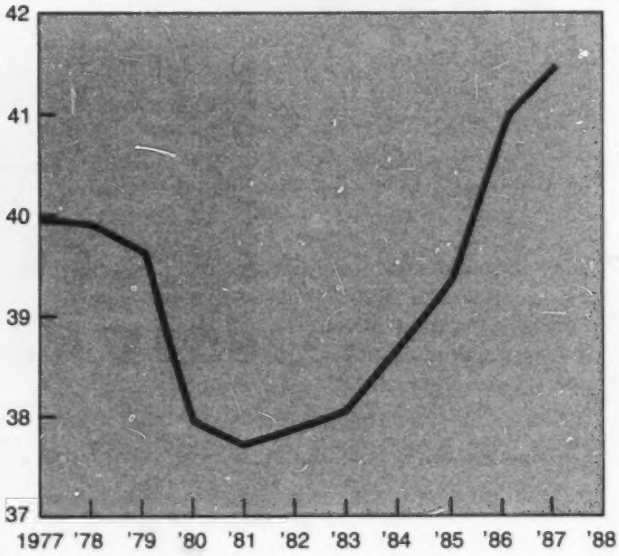
So our present situation looks very good on the surface. There is only one problem, the persistent imbalance between the world's major regions. If present growth is to continue smoothly there must be improvement in the U.S. balance-of-payments deficit. This implies a corresponding reduction in the European surpluses—particularly of Germany's—and in the Japanese surplus, but as yet nothing much has been done. The U.S. economy is still among the fastest growing, while on the other side, the German economy shows only sluggish growth. The result is continuing skittishness in the financial markets.

In an article published in *Le Monde* last January, Paul Volcker wrote, "The key to success will be maintaining confidence in the marketplace that necessary policy changes are being made. . . And it is the performance of the dollar in the exchange markets that is likely to tell the story of success or

failure in that necessary cooperative effort." There has been no clear sign of changes in behavior yet. This means that a serious threat still hangs over our heads: Either a lack of confidence will lead to another crash like that of October 1987 or to a shift in American policy in 1989 that will be much more drastic than changes that could have been eased in gently in 1987 and 1988, and that will lead to the risk of an out-and-out recession.

This is how the international situation is perceived in France and it gives rise to a certain degree of uncertainty. As for the French economy itself, on the whole it is doing fairly well. The excellent financial results of French companies deserve to be mentioned first. The upturn has been much stronger than expected. The gross profit margins of firms have reached levels similar to those seen in the years before the first oil crunch (see chart). This makes a rally in investment likely and 10 percent more capital expenditure in industry is foreseen in 1988.

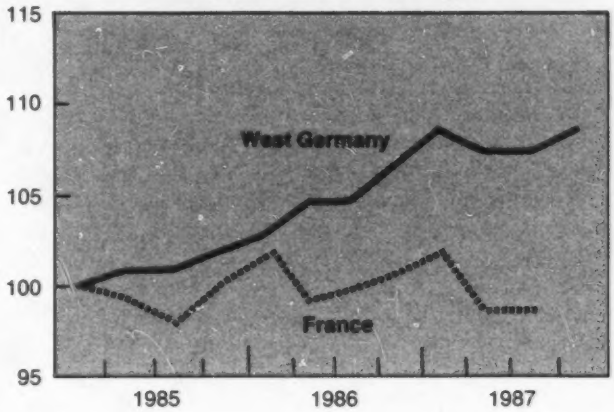
Corporate Gross Profits, France
percent of value added



The second mention should go to the excellent competitive position of French firms. International comparisons all show that their costs are fully competitive with those of their main European rivals and are even slightly lower than those of German firms at present.

Most of this excellent competitive performance can be explained by two factors. The first is an unprecedented productivity effort. French firms had fallen behind in the process of slimming down their work force, but they made up for lost time in the years between 1982 and 1987. The second factor has been a reduction in the nominal value of pay increases. This factor is downright revolutionary and has not been sufficiently emphasized. Since 1985, unit labor costs have stayed pretty much the same in the French manufacturing industry while in Germany they have kept on rising. As a result, the gap between French and German labor costs grew by 10 percent between the start of 1985 and the end of 1987, as the chart shows. The rise in the D-mark widens the gap by another 10 percent, making it a whopping 20 percent. This has played a large role in curbing inflation, which is now down at around 2.5 percent in France.

Labor Costs per Unit of Output in Manufacturing



Nonetheless, the accumulated deficiencies from 1975 to 1983 are still being felt. Investment cannot slacken for several years in a row without taking its toll somewhere. One look at the problems with the French trade balance confirms this. The trouble does not lie in price competitiveness; we know because we've checked. The problem is that French production is not sufficiently geared to world demand. Or, as experts put it in a 1985 report: "We are making too much steel and too few video recorders." Basically, the problem has remained the same, even though some improvements have been made. We have fallen behind and therefore we must continue our efforts. But will the international situation allow us to do so?

In terms of economic policy, the major events of the last two years have been:

- The lifting of price and exchange controls;
- A cut in company tax from 50 percent to 42 percent;
- A big wave of privatizations (unfortunately interrupted by the stock market crash), involving some 65 billion francs;
- An effort at budget cutting that has reduced the deficit by some 30 billion francs.

And all this took place within the framework of a policy to bring back economic freedom.

All in all, 1988 will be a year of marked improvement, with 2.5 percent GDP growth. But beyond that, the year 1992 and the completion of the Single European Market looms large on the horizon for French firms. This opening of internal European frontiers will call for a harmonization of legislation and taxes that will be no easy task. It will also require us to

think about developing industrial strategies on a Europe-wide scale.

The past performance of the French economy is encouraging. In retrospect, the productivity gains of the last twenty years have put France in second place, right behind Japan. France chalked up an average annual productivity growth of 3.9 percent between 1967 and 1987, in spite of being slowed by the slump resulting from the oil crisis. In order to succeed, France must be able to continue its growth, now that it has dug its way out of sluggishness, and not have it interrupted again. This explains France's particular alertness to developments on the world economic scene.

Waiting for the Next Recession. . .and Waiting

Michael C. McCracken

In 1988, the Canadian economy began to shift gears, with business nonresidential investment exhibiting a strong and widely based expansion, coupled with continuing strength in exports. Consumer growth is more modest and residential construction is declining from the peaks of 1987. As a result, final domestic demand will grow at about the same pace as the overall economy, instead of more rapidly as was the case in 1985-1987. The pace of overall economic advance, at 3 percent, is less rapid than the 3.9 percent in 1987, or the 5.7 percent from the fourth quarter of 1986 through the end of 1987.

The unemployment rate declined to 8.9 percent in 1987 from its peak of 11.9 percent in 1983. A further decline to about 8 percent is expected in 1988. Unemployment rates remain high outside of central Canada, presenting a continuing policy challenge for governments.

Inflation rates are running about 4 percent, buoyed by indirect tax increases and rising shelter costs in Ontario. But there is little expectation of any "breakout," with monetary and fiscal policy restraint in place and with recent appreciation of the Canadian dollar against the U.S. dollar expected to exert continuing downward pressure on prices.

As always, the outlook for exchange rates and interest rates is more uncertain. At present, Canadian interest rates are substantially higher than U.S. interest rates, as a matter of monetary policy (short-term rates about 200 basis points higher than comparable U.S. rates). Inflation control remains the priority of the Bank of Canada in spite of criticism from some circles. There is little expectation that the Bank will change its policy, unless the economy enters a recession.

Some easing of the exchange rate is expected during 1988, with an average of 79 U.S. cents per Canadian dollar for the year. This will still represent an appreciation of about 5 percent against the U.S. dollar.

Everyone seems to be waiting for the next recession! What is not appreciated is that this business cycle is different. In particular, real interest rates have remained high throughout the recovery; there is no overbuilding of housing; inventories are in line with sales; and capacity utilization has improved but remains ample in most sectors. In other words, none of the typical recession triggers are in place, and a further tightening of monetary policy, although possible, seems unnecessary.

Expansion and recession. The Canadian economy can continue to expand for a number of years to come. Growth of 3 percent or more is feasible, until the unemployment rate is lowered to 4 percent. But with current policies continued, it is likely that slower growth will materialize in 1988, 1989 and 1990. This weakness will be evident in a rise in the unemployment rate from current levels (slightly below 8 percent). A U.S. recession in late 1989 or 1990, as a result of some combination of tighter monetary policy and fiscal restraint, could trigger a recession in Canada at the same time.

Michael C. McCracken

"None of the typical recession triggers are in place."

It is not necessary to have such a recession. But without a change in the current monetary policy stance in Canada and with restrictive federal fiscal policy, added to pressures on provincial governments to move to restraint, the probability is high that we will have one before the end of 1990. Of course, governments will blame others and "ride to the rescue."

It is important to recognize that any forecast is conditional on a number of assumptions. In this case, in addition to fiscal and monetary restraint continuing, there is no major resource boom, no further drop in the personal savings rate, nor a large jump in the terms of trade in favor of Canada. Such favorable events can occur, but it is also possible to envisage a further tightening of monetary policy, another stock market "adjustment," or other unfavorable shock. Take this "reces-

sion" forecast as representing my judgment at this point in time. With new information I change my mind—don't you?

Financial instability. Real interest rates in Canada and the United States are too high. The high level of rates is dampening real investment, contributing to a maldistribution of incomes, creating instability in the finances for all levels of government, and eroding the financial base for key sectors such as agriculture and energy.

The maintenance of a large differential between Canadian and U.S. interest rates is adding to the problem by keeping upward pressure on the Canadian dollar, which is cooling down economic growth in the tradeable goods sectors (resources, manufacturing).

But can anything be done about it, or is it the "new international order?" It is at this point that differences in opinions arise. The persistence of high real interest rates since the early 1980s is taken as "evidence" by some that nothing can, or should, be done. I look at it as evidence of continuing monetary restraint, both in the United States and Canada, but with the conviction that it is not necessary, not "natural," and capable of being changed.

Failure to move will be reflected in growing debt-income ratios for debtors and rising asset-income ratios for creditors. At some point in time there will be a "debtors' revolt"—some would argue that it has already happened with the debt of less developed countries and loans to smaller agricultural and energy enterprises.

Unanticipated Fiscal Restraint

Nancy H. Teeters

For some reason people don't like to look back when talking about fiscal policy. What happened in fiscal 1987 is important, however, and yet it has been virtually ignored. The deficit in the unified federal budget fell from $221 billion in fiscal 1986 to $150 billion in fiscal 1987, a $71 billion decline. The accusation that I heard all fall and winter was that it was "dirty tricks:" the expenditure side was unnaturally low because of asset sales and the revenue side was too high because of tax reform. The expenditure side always has asset sales in it, sometimes the same ones proposed over and over again. More important than the asset sales in my opinion was that growth in defense expenditures fell from an average annual rate of 11 percent per year between 1981 and 1986 to 3.1 percent in 1987. The difference between an 11 percent growth in defense and 3.1 percent is $21 billion. The lower rate of defense spending was built into the fiscal 1987 projections. Total obligational authority actually declined in FY 1987. Nondefense expenditures were nearly $11 billion lower than projected in January 1988. On the revenue side, total receipts were $12 billion over the January 1987 estimate with a difference in nominal GNP from projected to actual of only 0.3 percent.

Looking closely at the defense projections for fiscal 1988, the total obligational authority is up only 1.3 percent and cash expenditures are projected to rise 1.2 percent. The small increases in obligational authority over the past two years are significant because almost all defense funds are subject to the appropriation process. That is not true for social security (where the revenues are automatically appropriated) or interest which is contract authority.

Actual defense expenditures through March are up 5.5 percent compared to 1987. What is more interesting is that cash outlays for Defense in the March quarter are more than $6 billion below the preceding quarter. Agriculture is 27.2 percent below a year ago and all other expenditures are up 6.2 percent. On the revenue side, through March, total receipts have increased by 7.4 percent compared to a year ago. April receipts are a crucial month, so we are not in a position on the revenue side for the story to be as convincing. The point I am making is that, contrary to almost all forecasts, the federal deficit may continue to decline. While this is very good news from the viewpoint of overall balance in the economy, it is an element of fiscal restraint very few anticipated.

Nancy H. Teeters

"The federal deficit may continue to decline."

The budget documents are of little help for fiscal 1989. First of all, they are the President's requests. Second, there will be a new president. Third, the new commission on budget deficit reduction reports in March of 1989. Out of ignorance, then, we are holding the defense figures level and letting the other expenditures, except agriculture, grow slowly.

The Federal Budget (as a percent of GNP)

	1980	*1987*
TOTAL EXPENDITURES	22.1%	22.8%
Defense	5.0	6.4
Payments to individuals	10.4	10.6
Other grants	2.2	1.2
Interest	2.0	3.1
All other	3.3	2.3
Offsetting receipts	–0.7	–0.8
TOTAL RECEIPTS	19.4	19.4
Individual income taxes	9.1	8.9
Corporate income taxes	2.4	1.9
Social security taxes	5.9	6.9
All other	1.9	1.7
DEFICIT	2.8	3.4

As we are all aware, the Reagan years have witnessed the greatest budget battles on record. It is not clear who won.

In fiscal 1987, federal expenditures as a percent of GNP had risen to 22.8 percent from 22.1 percent in 1980. Federal revenues were unchanged at 19.4 percent of GNP. And the deficit rose to 3.4 percent of GNP from 2.8 percent.

Defense and interest payments as a percent of GNP have risen by 1.4 and 1.1 percentage points respectively; payments to individuals (including some grants to states, like welfare) are up slightly; other grants to state and local governments and "all other" are down by 1.0 percentage points. Our priorities got reordered, even if the total expenditures didn't go down. As I remember the rhetoric, the total was supposed to go down, too. The revenue side is a continuation of a thirty-year trend. In spite of noisy battles over income taxes, individual income taxes as a percent of GNP remain around 9 percent; corporate taxes declined; and social security taxes have gone up. You'll notice that the total remained the same. That is also contrary to the rhetoric, as I remember it.

Monetary policy. I assiduously avoid forecasting monetary policy. The reason is that it is not planned out ahead of time the way the budget is. By its very nature, monetary policy reacts to developments in the economy. The Federal Reserve is frequently accused of making policy changes that are too late. The policy makers face a strange dilemma: they simultaneously have both too much information and too little. Times were very few when I (as a Federal Reserve Governor) didn't want to wait for one more reading on the unemployment rate, or capacity utilization, or inflation, or you name it. So what you are really asking for is an economic forecast and what I think the Fed's reaction to it would be.

I find the incoming data from the fourth quarter of 1987 and the first quarter of 1988 very erratic. Consumers and businesses stopped buying goods in the fourth quarter and inventories piled up. The preliminary data for the first quarter indicate that consumers bought cars and businesses bought equipment and trucks; inventories still piled up and everything else went down. There are price pressures in specific places like chemicals and paper, but it doesn't seem to be generalized. If I were still a central banker, I'd wait and see what happens next.

Although all the Governors are relatively new, the regional Presidents are not. The institutional memory of the pain of the 1979 to 1982 period remains. Therefore, my best judgment is that they would probably prefer to take a series of small steps rather than big ones. In my mind, that means small changes in interest rates with a fair amount of frequency in response to economic developments. If wage and price inflation remains quiescent, my general rule of thumb would be anything over 4 percent annual rate of growth in real GNP or anything under 2.5 percent would be cause for concern. Other people look at other things and they can always change their minds.

Finally, I would like to point out that historically the stock market peaks eight to ten months before the peak in economic activity. The four "false signals" did signal periods of adjustment: in 1963, the uncertainty surrounding fiscal policy; in 1966, the turmoil connected with the Vietnam war; in 1977, a short-lived run-up in oil prices; and, in 1984, the abrupt slowing in economic growth. I'm not yet ready to call the stock market crash of 1987 a non-event.

Appropriate and Sustainable Paths

John H. Makin

Contrary to the wailing about unsustainable budget deficits and excessive fine tuning of monetary policy, a strong case can be made that U.S. fiscal and monetary policies are on appropriate and sustainable paths. The conventional wisdom on fiscal policy, which surprisingly includes many chief executives who may have been influenced by Peter G. Peterson's October 1987 *Atlantic* article entitled "The Morning After," is that to avert disaster a new president will quickly have to reduce the deficit further through a combination of higher taxes and spending cuts.

A look at the budget numbers shows that one reason disaster has not yet befallen us is the simple fact that the rapid spending growth and lower taxes attributed to the "Reagan Revolution" ended three years ago. Since 1985 we have been on a path that will lead us almost to a balanced budget by the end of the next president's first term. This outcome requires no new taxes. It requires only that the growth of federal spending stays at the lower level already achieved after 1985. Over the past twenty years the average growth rate of federal spending measured in current dollars has been 9 percent per year. Since 1985 the annual growth rate of federal spending has dropped to 4 percent. If the growth of federal spending is held to 4 percent during the next administration, and revenues meet the Congressional Budget Office's forecasts, the 1993 deficit will be 0.9 percent of GNP, well below the 1973-1980 average of 2.4 percent.

Part of the reason why virtual elimination of deficit spending is well within the grasp of the next president is the fact that the Reagan years, taken as a whole, have not been low tax years. During 1981, 1982, 1987 and 1988 tax revenues were about $40 billion *above* the levels that would have been achieved had average tax rates during the two pre-Reagan administrations been applied. Taken altogether, had the average tax rates of the 1973-1980 years been applied during the Reagan administration, revenues would have been $140 billion lower than total revenues during the 1981-1988 Reagan years. The steady rise in the social security payroll tax and the post-1986 increase in corporate taxes have combined to increase federal revenues to about 19.25 percent of GNP in 1988. Tax increases (largely payroll tax increases) already scheduled will push taxes still higher after 1990. The chart shows that the upward tilt of the tax-to-GNP ratio during the 1960s will continue over the next 5 years because of existing tax increases already in the pipeline.

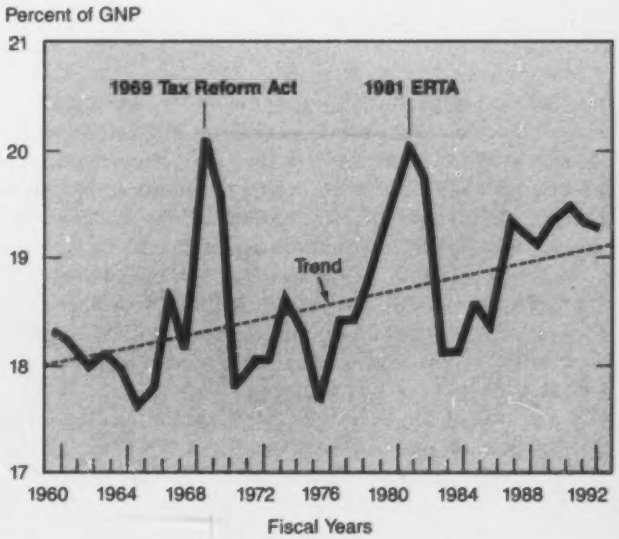
The real issue between the doom-and-gloom forecasters who want to raise taxes in 1989 and those who do not is the pace at which deficits ought to be eliminated. We are currently on a path that will bring deficits down from about 6 percent of GNP in 1985 to below 1 percent of GNP in 1993 without further tax increases. A tax increase might get us to the goal of a lower deficit faster but there are three compelling reasons to doubt that this will be so.

Higher taxes won't help. The first reason is a question. Will a $1 increase in taxes produce a $1 reduction in the deficit? The answer is very probably no. The effort to keep the growth of spending down to 4 percent since 1985 has required sharp cuts in the non-defense discretionary programs that contain the juiciest pork barrel projects so dear to members of the Congress. Congressmen are talking of "pent-up demand" to restore programs that have been cut in the course of reaching the goal of keeping spending growth at 4 percent.

John H. Makin

"An almost balanced budget by 1993."

Revenues as a Percentage of GNP, 1960-1992



Notes: Trend based on 1960-1980 revenues. ERTA is the Economic Recovery Tax Act.

Source: Office of Management and Budget, Congressional Budget Office, and author's calculations.

The second problem with higher taxes involves efficiency costs for the economy. Work done by leading economists at Stanford University and the National Bureau of Economic Research and reported in the 1985 Council of Economic Advisors' Report to the President suggests that an additional $1 in taxes costs the economy somewhere between $1.30 and $1.50. This result follows because the collection of taxes always involves economic distortions that are magnified when taxes are increased. This magnification effect is the reason for a cost to the economy 30 to 50 percent above the actual taxes collected.

The final problem with higher taxes, however they are engineered, is their potential to further slow the rate of economic growth. One of the reasons that the economy has remained surprisingly strong relative to the expectations of many forecasters over the past two years is the simple fact that the cutback in fiscal stimulus is being accomplished gradually, largely through spending cuts rather than through sharply increased taxes.

The international deficit. Besides the budget deficit there is the trade deficit and the growing accumulation of debts to foreigners that has turned the United States from the world's largest creditor nation to the world's largest debtor nation in just six years.

Peterson and some prominent economists raise a legitimate issue when they argue that, although there has been progress in reducing the budget deficit, the trade deficit remains stubbornly high at over $150 billion per year. This is true, of course, but here again it is important to examine the facts and to determine the reasons for the failure of the trade deficit to improve along with the budget deficit during 1987, and then to consider the outlook for 1988 and beyond.

The 1987 trade deficit expanded even while the budget deficit fell because of a sharp drop in private saving accompanied by a surge in private investment. The surge in private investment was due partly to an accumulation of projects awaiting the passage of the 1986 Tax Reform Act and partly to the prospective competitive improvement for U.S. producers from the sharp depreciation of the dollar. In this sense, the failure of the trade deficit to improve during 1987 was a downpayment on the means to achieve lower future trade deficits in the best way possible: with more exports.

As a result of a drop in private sector saving and the jump in investment, the 1987 net flow of money into U.S. private savings fell by more than $70 billion, thereby offsetting the drop in the budget deficit, which otherwise would have had a positive impact on the trade deficit.

But a look at the GNP statistics suggests that the most difficult phase of the trade-balance adjustment is now behind us. Largely unnoticed, the personal income saving rate jumped from 2.8 to 4.8 percent during the 4th quarter of 1987, and then held at 4.6 percent in the first quarter.

Overall, since the stock market crash, national income data suggest a $70 to $75 billion drop in net U.S. absorption of world output. Budget deficit forecasts for fiscal year 1988 are dropping to the $150 to $160 billion range due to faster-than-expected growth and lower-than-expected interest and unemployment rates.

Such a drop in U.S. absorption should cut the trade and current account deficits to annual rates below $100 billion by year end. This outcome is more optimistic than the current consensus and, were it to occur, would strengthen the dollar to the 150 to 160 yen range and lower interest rates on the long Treasury bond to below 8.5 percent.

Monetary policy. U.S. interest rates are on the rise, especially since the "disappointing" report on April 14 of a $13.8 billion U.S. trade deficit for February. The result was a weaker dollar and upward pressure on U.S. interest rates, conditional on the degree of dollar support other Group-of-Five central banks are willing to provide.

If the pressure on the dollar becomes too great, Japan's first response will be to increase pressure on the Federal Reserve to raise U.S. interest rates. Statements by Treasury Secretary Baker and other finance ministers immediately after the bad U.S. trade numbers appeared make it clear that they're hoping a manageable dollar-support operation can get them through the market's response to this set of trade numbers. There may be some conflict between Fed Chairman Greenspan and Treasury Secretary Baker on the timing of a possible interest rate increase engineered by the Fed.

Greenspan is responding in two stages. The first stage is to allow the Federal Funds rate to drift to the 7.0 to 7.25 percent range. If this is sufficient, Greenspan will stand pat. The coming statistics on employment, inflation, and trade will determine whether upward pressure on interest rates can stop with a modest rise in the Fed Funds rate.

Given the signs of robustness in the U.S. economy, if pressure on the dollar continues Greenspan probably is prepared to raise the discount rate by 50 basis points. His reasoning will be that such a step, while painful, will ultimately cost the economy less, that is, by doing it early rather than later. Federal Funds at or above 7 percent and the long bond well above 9 percent, if persistent, will require an attempt at yield curve flattening via a 6.5 percent discount rate.

The first step, allowing Fed Funds to drift to 7 percent, has taken the long bond to the 9.0 to 9.1 percent range. If step two is necessary, long-term interest rates could rise to the 9.2 to 9.4 percent range. Such interest rates would likely push the Dow back below 2000.

The outlook for interest rates and stocks, I believe, is conditional on the demonstrated fact that Mr. Greenspan is willing to tighten U.S. monetary policy if a weaker dollar and inflation pressures require it. In the short run, this means that interest rates might rise more rapidly under Greenspan than they would have under Volcker. Over the longer run, Mr. Greenspan's actions suggest that ultimately the path of U.S. interest rates and inflation will be downward. This should benefit equity prices.

Looking at the U.S. and Japanese economies together it is hard to avoid the conclusion that interest rates will have to rise. The Japanese economy continues to be very strong with

forecasts for the quarter beginning on April 1, 1988 now suggesting growth in the 5 percent range. This coupled with the rise of the Tokyo stock market to record levels virtually eliminates the possibility that Japan would try to relieve pressure on the dollar by lowering interest rates.

In view of the delicacy of the exchange market situation in the immediate aftermath of the bad trade report for February the Bank of Japan is unlikely to allow interest rates to rise over the next few weeks. To do so would only make their task of supporting the dollar more difficult.

Inflation—The Major Threat

Barry P. Bosworth

Despite the emphasis in public discussion on the risk of a U.S. recession, one would expect that inflation would be the major threat to an economy engaged in a spending binge of the magnitude currently enjoyed in the United States. The high value of the dollar and the excess capacity present in the world economy negated those fears in prior years, but increasing signs of inflation have become evident in recent quarters. It is becoming clear that inflation, and not recession, will be the major concern of the Federal Reserve in 1988.

The overall rate of inflation, as measured by the consumer and producer price indexes (table), clearly accelerated in 1987; but that increase was from an artificially low rate in 1986 when energy prices fell sharply. Exclusive of food and energy, however, producer prices at the crude and intermediate stages of production accelerated sharply throughout 1987, and those increases will pass through into finished goods in 1988. In several basic industries, such as steel, paper, and chemicals, capacity utilization rates are very high. In the past, price increases in these industries might be checked by the threat of imports, but today many operate under the umbrella of quantitative restrictions on imports.

Surprisingly, the anticipated sharp rise in imported goods' prices, following the fall in the dollar's value, has not materialized. In fact, prices of nonoil imports have risen only 3.6 percent in the last year. In part, this low rate of increase can be explained by continuing sharp price cuts in computers and computer parts. Exclusive of computers and petroleum, increases in imported goods prices did accelerate to an annual rate of 6-7 percent in the last two years; but the cumulative increase since 1982 has been far less than for domestically produced goods, and the relative price of imports remains very low.

Barry P. Bosworth

"Signs of inflation have become evident."

Alternative Measures of Inflation (annual percentage change)

	Year Ending				Quarterly (annual rates)
	1984:4	*1985:4*	*1986:4*	*1987:4*	*1988:1*
Prices					
Consumer price index	4.1	3.5	1.3	4.5	3.5
Producer price index	1.8	1.6	-1.9	2.4	0.8
Excluding Food & Fuel					
Consumer	4.8	4.3	3.9	4.3	4.5
Producer—finished	2.3	2.6	3.0	2.5	4.8
Producer—intermediate	2.4	-0.2	0.1	4.8	7.5
Producer—crude	-2.0	-4.4	0.1	23.5	11.8
Wages					
Average hourly earnings	2.8	3.1	2.3	2.7	2.8
Employment cost index	4.9	3.9	3.2	3.3	6.3[a]

[a] Includes Social Security tax increase; wage and salary increase alone was 4.0 percent.

On the other hand, there is little evidence of an acceleration of wage increases. In fact, adjusted for inflation, hourly earnings have fallen 1.5 percent in the last year and 7 percent in the last decade. With the unemployment rate down to 5.5. percent, one has to wonder how long workers will be willing to accept an erosion of their real earnings—particularly when their bosses are showing no such restraint. While demographic changes have reduced the rate of unemployment at which we would expect wage increases to begin to accelerate, all of the available empirical models of wage determination would anticipate an acceleration of wage inflation in 1988. Given the tremendous inertia of U.S. wage changes, major increases in wages should not be anticipated, but we also know that wages are usually the last component of the inflation process to respond. Once the process does heat up, it is difficult to turn around.

Certainly the magnitude of the 1980-1982 recession may have traumatized some of the most aggressive unions, and many workers continue to feel threatened by foreign competition and worry about job security. However, a continued erosion of real earnings in 1988 and some further reduction in unemployment are likely to change those attitudes.

If we assume the monetary authorities are looking at the same indicators, they must perceive inflation as an increasingly severe constraint on the economic expansion. Since labor force growth has now slowed to 1½ percent annually and productivity continues to rise at only about one percent, any growth of output in excess of 2½ percent is likely to result in further reductions in unemployment and additional inflation pressures. Now that most of the forecasts of future growth are rising to 2½ percent and above, higher interest rates and a more restrictive credit environment seem inevitable.

Little Support from Consumer Spending and Housing

Edward F. McKelvey

Nobody expected consumer spending and the housing industry to contribute much to economic growth in 1988, especially after the stock market crash. Yet the latest news on both fronts has been remarkably upbeat. Starts and sales of new housing units rebounded in February and March from their lowest levels of this expansion, while real consumer spending in the first quarter more than made up the ground lost in the fourth quarter.

Edward F. McKelvey

"No reservoir of pent-up demand."

The question before us is whether these latest developments are false starts or precursors of more strength. In both instances, analysis of the fundamentals indicates that little, if any, growth contribution can be expected for the remainder of this year and probably for 1989 as well.

In the case of housing, the potential for growth is limited by excess supply and slim prospects that demand will rise enough to absorb that supply. The oversupply is concentrated in rental housing, where vacancy rates have risen over the past four years to a level two and one-half percentage points above the norm (8 percent vs 5.5 percent). With more than 30 million rental units now in service, this gap implies that there are 750,000 to 800,000 more than the normal number of rental units now on the market. By contrast, the single-family market has shown no sign, until recently, of excess supply.

Two factors, in combination, explain why the oversupply of housing has been concentrated in the multifamily sector. First, the 1984-1987 decline in interest rates induced families who otherwise would have rented to purchase homes. This is evident both in the fact that new home sales during this period have exceeded the 650,000 annual rate that would have been consistent with household formation and the usual distribution of preferences between rental and homeownership and in the fact that rental vacancies began to climb significantly in late 1984. The failure of multifamily construction to contract in response to this increase was the result of the second factor: tax incentives to own rental housing. Only in early 1986, when it became clear that tax reform would substantially eliminate those inducements, did multifamily building begin to decline. The contraction has thus far failed to rectify the imbalance, however, because of further declines in mortgage rates (into early 1987), persistently high rental costs, and the normal lag between starts and completions of new units.

Unhappily for the homebuilding industry, prospects for absorbing excess supply through demand stimulus are poor. Currently, there is no reservoir of pent-up demand waiting to

occupy new housing units. On the contrary, because the backlogs of demand associated with the 1980 and 1981-1982 recessions had largely been cleared out before interest rates began to decline in late 1984, the effect of that decline has probably been to pull demand forward from future years, much like the effect of auto financing incentives on car sales. Furthermore, our research indicates that home sales are more sensitive to rate movements than rate levels. On this basis, mortgage rates at present do not look all that attractive compared to their average of the preceding year, particularly when account is taken of the extent to which home buyers offset the mid-1987 rate increase by taking out more adjustable-rate loans.

The degree to which households have been able to reduce the variability of financing costs over the past four years, by switching back and forth between fixed- and adjustable-rate loans, is illustrated by the chart at the bottom of the page. Since 1984, fixed-rate commitments have fluctuated through a range of 5½ percentage points, but the average cost of all financings has fluctuated only 4 percentage points. Thanks to the wider range of financing options, as well as better access to funds enjoyed by lending institutions, housing simply will not display as much sensitivity to interest rate cycles as it has in the past.

The notion that housing offers little support to the economy over the next six to eighteen months may not be terribly controversial. A similar claim about consumer spending would draw more protest. Economists have been impressed by the post-crash rebounds in spending and confidence and by the continuing strength in personal income growth. Consequently, they have raised their sights for consumer spending for the balance of the year.

Outside the service sector, however, increases in consumer spending were not widespread in the first quarter. Growth in spending on goods was confined to two areas—sales of autos and electronic gadgets. Both probably benefited from reductions in tax withholdings that took effect in January, and perhaps also from higher tax refunds paid out to some individuals in March. In addition, auto sales have been stimulated by aggressive price incentives, whose termination will most likely induce a slump. This void is not apt to be filled by spending on other items, if consumers' past propensity to finance auto purchases via reduced saving is any guide.

In general, we do not expect consumers to augment income by reducing their saving in the next six to eighteen months. In the wake of the stock market crash, the personal saving rate rose from around 3 percent to the 4.5-5.0 percent range, consistent with the loss in net worth that was sustained in the fourth quarter. Even if net worth grows more rapidly than income in the year ahead, caution in a financial environment perceived as being riskier will probably limit the extent to which consumers curb their saving. In this regard, while attitudes toward the use of saving and credit to finance purchases have

Note: Effective cost is a weighted average of rates charged on 75% loans with fixed and adjustable rates. The weights are equal to the proportion of total loans financed by either method. Last data point is March (preliminary).

Source: Federal Home Loan Bank Board.

recovered from their post-crash slump, they are still well below the readings that prevailed in 1985 and 1986, when reduced saving provided a significant supplement to income.

If this analysis is right, then growth in real consumer spending will be constrained by growth in real disposable income. While income growth has been impressive in the past two to three quarters, there are good reasons to expect it to slow soon to a trickle. Part of that simply reflects the absence of unusual factors, such as tax-law changes and income transfers, that on balance contributed to income growth in the first quarter. More fundamentally, wage increases have not kept pace with inflation, even in a period of subdued pressure on prices, and the gap will probably widen as a wave of commodity price pressures that has been working its way through the U.S. price structure reaches the retail level.

The primary driving force behind growth in income, particularly in the first quarter, has been the unusually large increase in employment. The surge in hiring that added one million workers to nonfarm payrolls this past quarter has no clear justification when the pattern of that hiring is examined closely. Gains relative to the preceding year were concentrated in construction, where output declined following two years of sluggish growth, and in retail trade and services, where current activity is not strong enough to explain an acceleration in the pace of hiring. In manufacturing, supposedly the key growth sector for 1988, employment growth has decelerated as business firms have reduced the rate of increase in output to contain an incipient accumulation of inventories. As this process continues, and as job gains elsewhere come back into line with output, employment and income growth should slow sharply.

Finally, a word about confidence. Many have taken the post-crash recovery in consumer confidence as an indication that consumer spending will resume growing at a significant pace. This interpretation ignores not only the caution about saving and borrowing mentioned above, but also the fact that growth in real consumer spending was in a downtrend for more than a year prior to the stock market crash, when the indexes of confidence were basically where they are now. Confidence indexes have not generally been reliable leading indicators of consumer spending. In all likelihood, confidence will fade once growth in employment and income slows.

The Rejuvenation of Industrial America

Rosanne M. Cahn

The vastly improved international competitiveness of U.S. manufacturing, replacement of an aged stock of capital goods, and shortages of several basic commodities are combining to contribute to a major burst of capital investment in the United States that should last until the next recession.

Rosanne M. Cahn

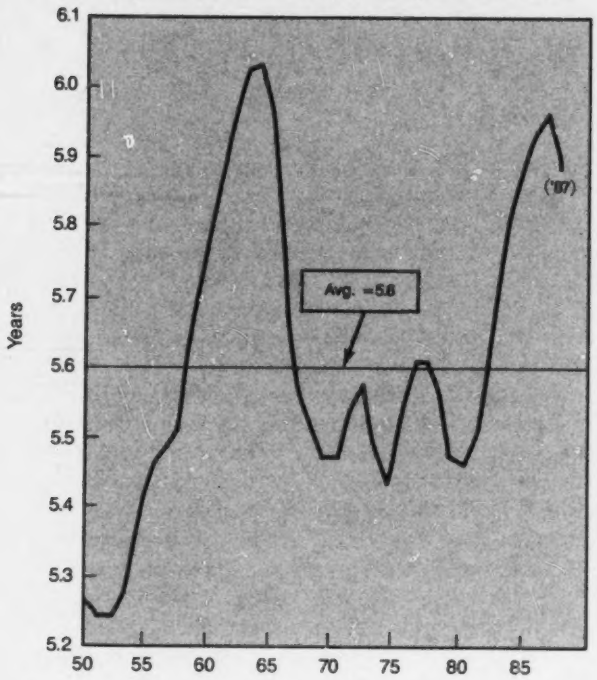
"A major burst of capital investment."

Strength in production of goods (rather than services), such as exports and capital goods, is accompanied by an upward move in the desired level of inventories, which are necessary to facilitate transactions or unavoidably accompany production, such as work-in-process inventories in the manufacture of long-leadtime items like capital goods. Consequently, once the near-term inventory correction stemming from the consumer retrenchment in the fourth quarter of 1987 is completed, inventory investment should become a positive force in the outlook.

The price competitiveness of U.S. exports has improved by a record amount in the past three years because of the decline in the dollar. The export boom, coupled with consumer demand that is difficult to check even with adverse financial market conditions, has resulted in rising capacity utilization rates for manufacturing. A major capital spending upswing began in 1987 as a result. Although utilization rates are currently edging down, they should rebound later in 1988 as demand from the recuperated consumer translates into higher production. The capital spending surge should pass through this mini-cycle without taking much notice.

From 1980 to 1986, the stock of many types of capital goods aged dramatically, as shown in the chart on page 21. This occurred, despite major tax incentives for purchasing capital equipment, because production in the United States was under pressure from the long recession and then by an extraordinarily strong dollar. This was the only six-year interval in

Age of the Stock of Capital Goods



Source: Bureau of Economic Analysis

the post-war period when the capacity utilization rate was at or below 80 percent continuously.

The improvement in the manufacturing environment in 1987 created the incentive for companies to start renewing the capital stock, which resulted in the downtick in the age shown on the chart. However, the process is far from complete. In the last major rejuvenation of the capital stock, real business equipment purchases rose an astonishing 12 percent per year (on average) for five consecutive years from 1961 to 1966, and nearly doubled in the 1961 to 1969 period. The economic conditions in the next several years may not be quite as favorable as they were in the 1960s, so real capital goods' purchases will probably not rise as rapidly. But they should outpace overall economic growth by a factor of two or three, as long as a recession does not develop.

The types of capital goods that are the oldest, whose purchases should be boosted significantly by replacement demand, include engines and turbines, mining and oilfield machinery, railroad equipment, agricultural machinery, tractors, electrical transmission and distribution equipment, fabricated metal products, ships, metalworking machinery and aircraft.

Another force boosting capital spending is the industry composition of the overall capacity utilization rate. The rate for manufacturing, at 82.3 percent in the fourth quarter of 1987 (and slightly lower now), was not much above its post-war average, as shown in the table. However, the dispersion of industries around the average is large, with three industries exhibiting a shortage environment: textiles, paper and chemicals. The rates in the metals industries are also high. The shortage industries are likely to increase capital spending rapidly while two of the industries with low rates, electrical and nonelectrical machinery, should benefit from a rapid rise in the demand for their product and start increasing their own capital outlays. Consequently, the composition of the capacity utilization rate implies a greater demand for capital goods than would be inferred from its average level or rate of change.

Many of the same forces that are boosting capital equipment purchases should also spur industrial plant construction. The upswing is not apparent in official statistics yet. However, the lags involved in making major decisions to construct new plants and the volatile financial environment may explain why it is taking a long time for greenfield construction to get started.

The outlook for every type of fixed investment is not positive, however. An ongoing environment in which the United States will be producing more and consuming less in order to diminish the trade deficit implies that investment for domestic purposes, such as housing, stores and office buildings, will be declining. Furthermore, not all of the components of the stock of capital goods have aged; the stock of computers for example is "new" by historical standards, suggesting purchases of computers may be more vulnerable to delay in the soft part of economic mini-cycles.

Adding up the pieces and factoring in the various forces, we expect real business fixed investment to rise around 10 percent for the four quarters of 1988 and to advance at a rate well above the growth rate in real GNP during 1989.

Industry Capacity Utilization Rates

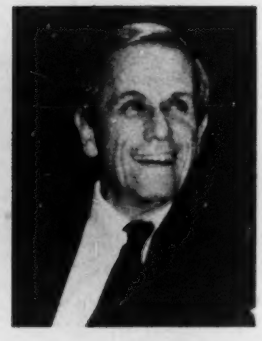
	1987:IV	*PostWar Average*	*Difference*
Manufacturing	82.3%	81.9%	0.4
Food & beverages	80.0	82.5	-2.5
Textile mill products	92.8	86.9	5.9
Paper & products	95.8	89.4	6.4
Chemicals	84.8	80.5	4.3
Petroleum	85.4	88.8	-3.4
Rubber & misc. plastics	88.4	86.0	2.4
Other nondurables	86.3	86.0	0.3
Stone, clay, glass	81.4	80.7	0.7
Iron & steel	90.4	81.0	9.4
Nonferrous metals	86.7	82.8	3.9
Fabricated metal products	79.9	80.2	-0.3
Nonelectrical machinery	76.8	79.7	-2.9
Electrical machinery	76.5	81.1	-4.6
Motor vehicles	80.0	80.3	-0.3
Other transportation equip.	88.3	74.3	14.0
Instruments	79.3	81.9	-2.6
Other durables	81.7	81.6	0.1

Source: Federal Reserve Board.

World Credit Markets

Stephen H. Axilrod

U.S. domestic, and also international, financial markets are being influenced by the somewhat surprising degree of strength in major world economies following the stock market crashes of last October. In contrast to the received wisdom toward the end of last year, the real sides of the U.S. and other economies have apparently ignored the crashes, with the result that underlying credit demands have held up reasonably well. The adverse effects of the crash appear limited mostly to stock and bond trading segments of the financial services industry: Investors, at least in the United States, have remained timid and uncertain, with a consequent fairly large reduction in the volume of activity in stock and bond markets along with a steepening of the yield curve as investors have become more risk averse.



Stephen H. Axilrod

"Upward pressure on interest rates worldwide."

Uncertainties affecting securities markets have not yet been reflected in any significant further deceleration of domestic spending in the United States. Indeed, after showing little change in the fourth quarter of last year in the immediate wake of the stock market crash, domestic spending for final goods and services (after allowing for the erratic effect of certain agricultural support programs) rebounded in the first quarter of this year to a pace that was greater than the nation's capacity to produce over the long term. The problem, of course, is that domestic final sales should be expanding considerably less than the nation's potential output so as to provide room for a steady reduction in our trade and current account deficits.

We are now to a point where important segments of industry are apparently convinced that they are, and can remain, truly competitive internationally. That means more active utilization of existing plant capacity and more spending for new plant and equipment. However, at near full employment, there is precious little room for such expansion without adding to inflationary pressures, unless spending by consumers or the government, or both, are restrained.

The underlying difficulty for U.S. credit markets, and by extension world markets, is the inability of the United States to save enough to meet its domestic requirements at near full employment. Unless there is confidence that the associated need to import saving from abroad will diminish significantly over time, the natural consequence is for the value of the dollar—which is seen to be in continuous oversupply—to decline, as has been manifested in exchange markets during recent years and in the absence since the spring of last year of significant, sustained interest in U.S. bonds by domestic or foreign investors. The stock market crash in October of last year should also be viewed in some degree as another aspect of this crisis of confidence in the dollar, even though by any normal standard equities had become highly overvalued.

It could have been hoped that the crash would lead to a rise in the personal saving rate and thus, in that way, to some reduction in the domestic gap between saving and investment. The personal saving rate has risen in recent months, but only to around 4¾ percent—above the average of the past two years but still well below historic norms. With only limited progress in reducing the federal budget deficit this year, it is obvious that the need for the United States to borrow from abroad remains large. It is, in practice, unduly large, particularly since many major industrial countries are now experiencing a rather good economic expansion that will tend to absorb their own domestic saving as investment demand grows relatively rapidly, making less saving available to other countries. A broader-based world expansion will also work to diversify the foreign outlets for saving that is exported abroad by the surplus countries, as more and more countries are perceived to be economically attractive. All of that could well portend upward pressure on interest rates worldwide along with a continuing erosion of values in the dollar currency and bond markets as the United States seeks to attract a relatively less available world saving supply.

Whatever further upward interest rate pressures may emerge in the United States may be limited, however, either if the Federal Reserve tightens promptly enough to contain domestic spending or if such spending weakens for other reasons, such as an exchange market or stock market crisis that erodes confidence or, more constructively, a gradual updrift in the saving rate. In general, so long as inflation can be contained to the 3 to 4 percent area or even reduced—which will be difficult if nominal wage increases begin to accelerate—one can expect very real restraint on the economy as long-term interest rates approach double digits.

Assuming that some real restraint is not too long delayed, the odds are that over the longer run of a year or two U.S. interest rates will be noticeably lower than now and spreads between U.S. and foreign interest rates will be narrower. Even

so, the value of the dollar on exchange markets probably will bottom out as the inevitable, in one way or another, slowing of domestic spending improves the trade deficit noticeably and as the new U.S. Congress in 1989 takes additional restrictive budgetary action that further narrows the domestic saving-investment gap. For the Congress to take such action, however, probably requires that the U.S. economy not be in recession during 1989; if it is, there will be, unfortunately, one more interest rate cycle to go through before domestic saving and investment can be balanced at near full employment.

Stock Market Fears Overstated

Michael H. Sherman

Ever since the October 19th stock market crash, abnormality has been the rule of the day in the equity market. The shock to investor confidence generated by the 508-point plunge is still affecting market participants in a profound and often contradictory manner. The first reaction to the crash by many investors was to assume that the world was going to fall into a depression. These investors raised cash immediately and have used every rally to reduce equity positions. The fact that the market is still substantially above the levels reached October 19th reflects injections of liquidity by the Federal Reserve and, importantly, the massive infusion of new money into the market that took place in the first quarter through mergers and acquisitions.

Michael H. Sherman

"The outlook for equities is positive, but not necessarily robust."

Since the crash, the economy has continued to expand (which nevertheless has not reduced the anxiety of those fearing depression), and that has raised new concerns about an interest-rate-led bear market a la 1987, when the Fed tightened to head off a buildup of inflation expectations and pressures. That these two fears—one depression and the other cyclical boom—can be held by investors at the same time is a testament to the disorientation caused by the crash.

A third factor in the market is also affecting stock prices, and that is the disenchantment of investors with the volatility of equity prices, which presumably is caused by program trading.

Understanding these three investor fears is the key to assessing the outlook for stock prices. Many profess to see a lower stock market, especially if interest rates work higher, but the extent of the market's risk from current levels is uncertain because the downward pressure of equity prices could occur at a time when other fears and anxieties are ameliorated. Conversely, there is no doubt in our mind that the market could move higher if the economy continues to expand at a moderate rate and inflation and interest rate fears prove premature. Our earnings forecast is now $22.25 for the S&P 500 (versus $17.50 last year), which implies continued GNP growth along the lines of the first quarter. We believe this growth rate will keep interest rates near present levels, but it does not necessarily indicate anything higher than 9.0-9.25 percent on long Treasury bonds. As earnings come through and some of the more flamboyant fears of depression subside, the stock market could adjust to higher levels, closer to 2200-2300 on the Dow Jones. That may seem an optimistic case to many, but for us it is the best case. It assumes that all of the present fears in the market are overstated.

It is unlikely, however, that price gains on the averages will be more than 15-20 percent—even in the best of circumstances. Uncertainties related to the election and the post-election environment will interact with cyclical forces to keep investors on guard against the potential for recession, if not in 1988, then possibly in late 1989 or early 1990. The end-of-cycle mentality will wax and wane but will not disappear until the cycle itself is complete. As a consequence, each successive rise in profits will be valued by a smaller increment, and stock price multiples will continue to contract.

This latter assessment could, of course, be altered if there were a shift in perceptions regarding the dollar. At the present time, the U.S. is financing its current account deficit through foreign central bank purchases of U.S. Treasury bills. Private capital flows into U.S. bonds and stocks, which had a buoyant effect on U.S. financial asset prices in 1986 and early 1987, have all but disappeared. In fact, foreigners have been net sellers of U.S. equities. There is a chance, albeit a slim one, that progress on the U.S. trade deficit will become more manifest, leading investors around the world to reassess the direction of the dollar from negative to neutral. If that were to occur, the U.S. markets could rise further under the impetus of renewed flows of foreign capital. This is a possibility, but it is not predictable. Therefore, although the outlook for equities is positive, it is not necessarily robust, especially when compared with recent years.

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The Conference Board

Managing Pension Funds in a Volatile Environment

How major U.S. companies are:

- *Setting investment policies*
- *Allocating assets*
- *Selecting and appraising money managers*
- *Employing new investment techniques*
- *Voting pension fund proxies*

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Managing Pension Funds in a Volatile Environment

by Patrick J. Davey

Introduction

Assets of U.S. private pension plans have soared in the past several decades, climbing from $12 billion in 1950 to almost $1.2 trillion at the end of the first quarter of 1987. The increase in value, especially in recent years, has been so great that, through reversions, hundreds of corporate sponsors of such arrangements have used billions of dollars in excess pension funds to finance their regular business activities.

Much of this growth traces to investment gains, especially to an almost fourfold increase in stock prices during the five-year period ending in mid-1987. But since then, the stock market crash of October 19 and a less ebullient economic outlook have heightened concern not only about the investment approaches of pension funds, but also about the extent of their involvement in the affairs of companies whose shares they own. What follows, based largely on results of a Conference Board survey undertaken at about the time of the recent market bottom, is an exploration of these issues.

Method

Replies to a letter of inquiry addressed to over 60 large and, for the most part, publicly owned companies supplied data for this study. Additional information was developed in interviews with executives of some of these companies and with other knowledgeable pension fund sponsors and money managers.

Two mailings were involved: The first was dated October 13, 1987, less than a week before the October 19 stock market crash; the follow-up letter was mailed on December 15, 1987. Responses were received from late October 1987 through early February 1988. Most firms, that is, were responding *after* the October market crash. The table below provides a general profile of survey respondents:

Type of Firm	Number	Percent of Total
Manufacturing	84	67
Utility	26	20
Retail-Wholesale	7	5
Service	6	5
Transportation	4	3
Total	127	100%

Highlights

Corporations take a vital interest in how their pension funds are administered. Most fund sponsors surveyed make their objectives and requirements known through written policy statements, which are used to guide the investment practices of money managers. Such statements include directives on asset mixes, as well as return on investment expectations. Many firms encourage the acceptance of a fair degree of risk taking in order to secure targeted rates of return, as, e.g., by permitting equity exposure to exceed 50 percent of portfolio investments.

Most responding companies rely on *outside firms* to serve as portfolio managers, but some share this responsibility with independent firms and a few shoulder the job themselves. When choosing outside managers, past performance, staffing, and investment focus are the principal criteria relied upon by many companies. Compensation for such managers generally accords with established fee schedules, but negotiated and performance-based arrangements are also appearing on the scene.

Indexing to secure returns comparable to those of the market as a whole is popular with those respondents who view it not only as a means of obtaining satisfactory results but also as an easy route to diversification. Other advocates of this investment method appreciate the generally lower management fees.

Portfolio insurance (a technique for protection against market breaks) was mentioned only by a small minority of survey participants. Many of those who do not rely on portfolio insurance question its effectiveness.

The vast majority of pension funds surveyed delegate responsibility for *voting pension proxies* to investment managers or trustees. However, some of these companies require their representatives to adhere to special instructions in casting their votes.

Prominently mentioned as possible new additions to pension portfolios by many of those queried are *international holdings*, *venture capital commitments*, and *real estate investments*. Others do not pinpoint investment vehicles for the years immediately ahead, preferring instead to take advantage of opportunities as they arise.

Glossary

Here are definitions of some of the special terms that sometimes surface in discussions of pension fund investing:

Beta: Measure of a stock's riskiness vis-a-vis that of the market as a whole, which is assigned a beta of 1. Thus an individual stock or a portfolio of stocks with a beta of 1.5 would reflect high sensitivity to market moves.

Closet indexing: Investing by a fund manager in a selection of securities designed to produce results closely approximating those realized by a recognized market indicator, while professing to offer active management based on a claimed skill, such as superior stock picking ability.

Dedication: Synchronization, usually through specially designed bond portfolios, of pension fund investment returns and payment obligations.

Guaranteed Income (Investment) Contracts (GICs): Binding agreements that promise investors a specified rate of return regardless of how the investments of the guarantor fare.

Hypothecation: Pledging of securities held in a portfolio as collateral for borrowings without any surrender of ownership interest.

Immunization: Portfolio design technique intended to protect investments in bonds from the effects of interest rate swings.

Investment grade bonds: Long-term debt investments possessing specified ratings from recognized agencies (usually BBB or higher), which are generally held to qualify them as investment holdings for institutions observing the prudent man rule.

Option: A contract that permits the holder to purchase (call option) or sell (put option) stocks or other assets at a fixed price within a given period ("American"-style option).

Index option: A call or put option for which a stated index (such as the S&P 500 index) is the underlying asset. Used for hedging or speculation on the direction of market moves.

Repurchase agreement: Simultaneous sale of an asset and agreement to repurchase it for a set price on a fixed date. The arrangement has the basic characteristics of a secured loan.

Reversions: Transactions whereby sponsors that have settled or fulfilled pension obligations recover plan funds in excess of obligations to use for general corporate purposes.

Sponsor: Company that assumes responsibility for pension plan designed to provide employees with retirement income.

Investment Guidelines

Pension benefit payments derive primarily from two sources: company contributions and investment returns. Realizing that the larger the returns, the smaller contributions need be, corporate sponsors devote considerable attention to formulating and adhering to investment guidelines. After all, lower outlays mean greater profits.

The appendix starting on page 20 contains a variety of investment guidelines issued by participating companies. Some are narrowly focused, providing instructions for the management of a single class or even subclass of assets, such as small company stocks. Others provide general guidelines for the investment of all assets held in trust funds. Still others serve as supplements to general policy statements, and zero in on particular classes of assets.

Most of these guidelines are just that—statements that provide instructions to managers on the investment of pension funds. But some are issued as letters to investment managers who are requested to confirm their acceptance of the directives in writing.

With few exceptions, these illustrative investment guidelines contain sections on the return expectations of sponsors. They provide representative indications not only of the actual goals set for entire portfolios or individual components, but also of the various criteria to which these objectives are tied.

The use of written policies to guide pension investment is widespread among survey respondents. Sample statements reveal a variety of forms, but nevertheless contain common elements, including expositions on or instructions regarding:

- Basic beliefs and objectives;
- Target rates of return;
- Risk postures;
- Asset allocations;
- Constraints; and
- Appraisal approaches.

Basic Beliefs and Objectives

Some pension fund sponsors include explanations of investment philosophy and concise summaries of objectives in their guidelines. For example, those seeking growth in assets often express a willingness to invest in equities and assume the greater volatility such investments entail. Frequently stated investment goals include: preserving capital; maintaining adequate funding; optimizing asset growth; complying with the requirements of ERISA (Employee Retirement Income Security Act of 1974), particularly those related to fiduciary responsibilities; and ensuring sufficient liquidity.

Target Rates of Return

In an earlier Board survey, some companies reported that they relied on qualitative statements—calling for a growth rather than an income orientation, for example—to direct the activities of investment managers.[1] This is seldom so today; most spell out investment goals in quantitative terms, which are frequently relative rather than absolute—e.g., matching or exceeding market indexes, universes of similarly constituted funds, inflation measures, or interest rate assumptions used for actuarial purposes.

Among survey respondents, many investment guidelines simply call for returns on equity investments to exceed a market average—usually that recorded by the Standard & Poor's 500 index. Others target better-than-average performance more precisely by directing managers to outdo S&P 500 returns—by up to hundreds of basis points or by 20 percentage points or more, over varying periods. Still others, mainly those whose stock portfolios are passively managed (see p. 12), set index matching goals for their equity portfolios.

The survey pattern is similar for fixed-income investments, with many sponsors targeting, but not specifying, returns above a certain average. Several set index-matching goals. The Shearson Lehman Government/Corporate Bond Index and the Salomon Brothers Broad Investment Grade Bond Index are popular norms. When results in excess of the standard are explicitly set they tend to be less ambitious than those set for their equity counterparts, probably in recognition of the historically lower return patterns of fixed-income securities.

Returns for balanced portfolios—those containing blends of equity and fixed-income investments—are generally expected to outpace norms, which are often specially devised to complement the makeup of such funds. One balanced portfolio, for example, has as an objective to "exceed the rate of return of the performance standard by 100 basis points per annum (net of fees) . . ." (The performance standard is 60 percent of the S&P 500 index plus 40 percent of the Salomon Brothers Broad Investment Grade Bond index.)

Investment policies sometimes target higher returns for alternative investments than for stocks and bonds. For instance, one surveyed company sets annualized returns of 1.5 to 2 times those of the S&P 500 index over a 5 to 8-year cycle or a minimum of 20 percent compounded annually for venture capital and leveraged buyout commitments. Another calls for "the highest possible return" on its investments in oil and gas properties. Real estate returns are also expected to outperform averages, with several fund sponsors targeting better-than-average performance together with minimum gains of five percent or more annually over a market cycle.

Where standards relative to the achievements of other funds exist, participants tend to insist on far more than adequate performance. Comparisons are typically made with similarly constituted funds, and rankings in the top half and even top quartile of such groups are frequently targeted. Occasionally such goals apply only to performance in down markets.

Many sponsors express their targeted returns in real terms. Some surveyed firms report seeking real rates of return (nominal rates minus inflation rates) ranging from 2 to 10 percent. Putting this approach another way, others call for returns ranging from 1 to 6 percent above the inflation rate. Others prefer to target but not specify returns greater than the inflation rate, usually as measured by the consumer price index (CPI).

Still others target returns that at a minimum match the interest rate assumptions used for plan funding purposes. Some surveyed firms indicated that they are currently assuming interest rates in the 7 percent to 9 percent range. Such rates are in line with a recent survey on plan funding that found an average interest rate assumption of 7.8 percent among participating firms.[2]

Risk Postures

Whether stated in qualitative or quantitative terms, risk guidelines are intended to convey the sponsor's position—aggressive, moderate, or conservative—with regard to investment practices.

Before adopting a position on risk, pension sponsors consider a number of factors, including: the company's own financial conditions and prospects, work force demographics, and the funding needs of retirement plans. Sponsors then determine their capacities to tolerate variations in investment returns and set policies accordingly.

Some sponsors describe risk postures in general terms. For example, one firm's policy includes this statement: "While permanent loss of capital is to be avoided, the risk of historical levels of short-term volatility in the equity market is acceptable." Another's risk policy indicates "a willingness to tolerate some interim fluctuations in market value and rates of return in order to achieve the objectives . . . and a desire to limit the volatility in the fund's rate of return to a level that is not substantially greater than the average volatility experienced by other U.S. retirement plans." Yet another's holds that "consistent rates of return with minimum volatility are needed characteristics for successful long-range operation of the pension plans." One company describes the attitudes of its Retirement Committee toward risk, volatility, and loss this way:

[1] Patrick J. Davey, *Current Directions in Pension Fund Management*, Conference Board Information Bulletin 39, 1978, p. 6.

[2] *The Compensation and Benefit File*, The Wyatt Company, Volume 4, Number 2, February 1988, p. 7.

The Committee is willing to trade off some potential opportunities for gain by encouraging the investment manager to assume a moderate risk posture. For example, this may mean sacrificing some potential opportunities for gain during rising markets in order to avoid large potential losses during declining markets.

The Committee recognizes the traditional capital market pricing theory that maintains that over the very long term the risk of owning equities should be rewarded with somewhat greater return than available from fixed-income investment. Consequently, some moderate risk-taking is justified as a long-term method of maintaining a potential control over pension costs.

Consistent year-to-year results are preferred to large fluctuations in return.

The manager's anticipation of intermediate-term (six to 18 months) market swings should influence investment decisions.

Likewise, profit taking is encouraged when the manager anticipates major changes in the economy or the capital markets.

More companies are presently quantifying risk limits for their pension funds than was the case when the Board last looked at such attitudes. Now characteristics are being set in betas, mathematical criteria that relate changes in fund values to changes in market values, or in standard deviations, which measure variability about averages, or both. Betas of up to 1.5—50 percent greater than the market as a whole, which is assigned a beta of 1—have been set for stock portfolio segments. For example, a beta-oriented statement on risk directs: "The portfolio beta for equity holdings should normally range between 1.0 and 1.4." Similarly, a statement detailing risk for different classes of investments requires "that the beta of the total equity account should be less than or equal to 1.05 . . ." and specifies that "the standard deviation of monthly returns [on bonds] should be less than or equal to that of the Shearson Lehman Government/Corporate Bond Index."

Asset Allocations

Perhaps the most basic indicator of a sponsor's position on risk and return is the asset mix chosen for the pension fund. (Traditionally, equity exposure is held to produce higher returns but entails greater risk than fixed income.) Although diversification of assets helps to spread risks, it moderates returns. Portfolios consisting of a single class of assets—bonds, ordinarily—occasionally appear; they usually serve a special purpose, such as funding the benefits of a particular group of retirees. Asset allocation guidelines set limits on the portion of equity, fixed income, cash, and alternative investments—including equity real estate, mortgages, private placements, venture capital, leveraged buy outs and the like—that can be included in trust funds.

Most sponsors, either independently or with the assistance of outside specialists, assess various asset allocations to determine the optimum blend for pension funds. Sometimes computer simulations designed to provide quick answers to "what if" questions play an important role in the process.

In firms that predetermine their asset mix, consideration is given to overall funding needs, the relationship between fund assets and liabilities, the asset classes to include, the emphasis to place on each, and the prospects for the economy. Some also consider the extent and timing of permissible shifts in fund holdings.

Table 1: Asset Mix Limits in 77 Participating Companies' Pension Plans

(Manufacturers: 51 companies)

1. 0%–100% equities
2. 45%–85% equities
   15%–55% fixed income
3. 70%–80% equities
   10% international
4. 60%–80% variable
   20%–40% fixed income
5. 50%–80% equities
6. 20%–80% equities
7. 80% equities
   10% real estate
   10% cash
8. 80% maximum in equities;
   remainder in fixed and other assets
9. 55%–75% domestic equities
   5%–15% international equities
   5%–15% fixed income
   5%–15% real estate
   0%–10% cash
10. 75% equities (maximum)
11. 75% equities
    25% fixed income
12. 55%–75% equities
    25%–45% other
    (maximum 15% real estate, maximum 5% optioned equities, maximum 5% mortgages)
13. 50%–75% equities
14. 25%–75% equities
    20%–50% fixed income
    5%–30% cash
15. 0%–75% equities
    25%–100% fixed income
16. 70% equities
    15% fixed income
    15% real estate
17. 70% equities
    15% fixed income
    10% real estate
    5% short-term reserves
18. 70% equities
    30% fixed income
19. 50%–70% equities
    30%–50% fixed income
20. 40%–70% equities
    30%–60% fixed income
21. 65% equities
    30% fixed income
    5% real estate
22. 55%–65% equities
    12%–18% fixed income
    9%–11% real estate
    8%–12% venture capital
    3%–8% cash
23. 55%–65% equities
    25%–35% fixed income
    0%–10% real estate
    3% venture capital
    2% cash

24. 55%–65% equities
15%–25% fixed income
15%–25% real estate

25. 50%–65% equities
35%–50% fixed income
0%–20% cash and equivalents

26. 35%–65% equities
35%–65% fixed income and cash equivalents
10% special purpose funds, e.g., real estate

27. 60% domestic equities
20% international equities
20% equity real estate

28. 60% equities
40% fixed income

29. 60% equities (maximum)
40% fixed income (minimum)

30. 60% equities

31. 60% equities (maximum)

32. 60% equities (maximum)

33. 60% equities
40% fixed income

34. 40%–60% equities
40%–60% fixed income

35. 45%–60% domestic equities
10%–20% international equities
10%–20% real estate
0%–10% venture capital
8%–20% domestic fixed income
2%–8% international fixed income
0%–100% cash

36. 40%–60% domestic equities
0%–10% international equities
25%–45% fixed income
0%–15% real estate
0%–10% cash and short-term

37. 40%–60% equities
40%–60% fixed income

38. 58% equities
21% fixed income
4% cash
4% equity real estate
1% venture capital
1% international
11% (not indicated)

39. 40%–60% domestic equities
20%–35% fixed income
10%–15% international equities
5%–15% real estate
0%–5% venture capital

40. 55% equities
45% fixed income

41. 40%–55% equities

42. 50% equities

43. 40% domestic equities
10% international equities
40% fixed/floating income
10% real estate

44. 35% domestic equities
20% international equities
15% real estate
30% fixed income

45. 10%–35% domestic equities
0%–5% international equities
10%–25% fixed income
0%–10% real estate
35%–75% cash and short-term

46. 33% equities
33% fixed income
33% cash or cash equivalents

47. 20% domestic equities
20% equity real estate
60% cash equivalents, domestic common stock or a combination of the two

48. 98% fixed income

49. 100% fixed income (including real estate)

50. 100% fixed income

51. Bonds are not to exceed actual present value of amounts prospectively payable all former employees in receipt of pensions. Distribution of remaining assets between equities and cash or equivalents will be determined by a decision rule in which the ratio between the two is a function of the price to book value ratio of S&P 400. The equity commitment drops from 100% at a ratio of 1.2 to 40% when the ratio is 2.2 or more, for example.

(Utilities: 16 companies)

1. 40%–75% equities
15%–50% fixed income
5%–20% cash

2. 55%–70% equities (including 10% real estate)
30%–45% fixed income

3. 50%–70% equities
40% fixed income and other

4. 65% equities plus 10% cash equivalents
20% fixed income
5% cash equivalents

5. 55%–65% equities
30%–40% fixed income
0%–5% equity real estate

6. 45%–65% domestic equities
5%–15% international equities
15%–30% fixed income
5%–15% real estate
0%–10% other (e.g. venture capital)

7. 60% equities
13% fixed income (active)
12% fixed income (passive)
8% real estate
7% convertible bonds

8. 60% equities
35% fixed income
5% cash and cash equivalents

9. 60% equities
30% fixed income
10% equity real estate

10. 50%–60% equities
35%–45% fixed income
10%–20% real estate
5%–100% short-term fixed income

11. 40%–60% equities
40%–60% fixed income

12. 40%–60% equities
15%–35% fixed income
10%–40% cash
5%–15% real estate

13. 40%–60% equities
25%–35% fixed income
5%–15% bonds
5%–15% real estate

14. 40%–60% equities
40%–60 fixed income

15. 50% equities at price to book ratio of 1.8 for S&P 400

16. 30% equities (maximum)
10% alternative investments (maximum)
70% fixed income (maximum)

(Wholesale—Retail, Service, and Transportation: 10 companies)

1. 75% equities and real estate
25% fixed income

2. 50%–70% equities
30%–50% fixed income

3. 50% equities (maximum)
50% fixed income (minimum)

4. 35%–45% equities
30%–40% fixed income
10%–20% hybrid securities
0%–5% other
0%–5% cash

5. 35%–45% equities
35%–45% fixed income
5%–15% cash
0%–15% real estate

6. 30% equity (minimum)
30% fixed income (minimum)

7. 20% equities
70% fixed income
10% real estate

8. 20% fixed income (minimum)

9. 36% cash
57% fixed income
6% real estate
1% venture capital

10. 100% fixed income

Practice varies on the setting of limits. Some companies prefer to pinpoint the level of various components, while others rely on ranges, sometimes quite broad, to define acceptable mixes. But regardless of approach, there are substantial differences among sponsors (see Table 1). And, as might be expected, individual company limits also differ from the average asset allocation position of the top 200 pension funds, which in September 1987 reflected: stocks, 47.1 percent; bonds, 31.6 percent; cash, 8.2 percent; and alternative investments, 13.1 percent.[3]

All but one utility providing details on allocations permit equity to constitute 50 percent or more of pension fund holdings. This is also true of roughly four out of five manufacturing firms. But survey companies in other lines are more conservative; only four out often set asset mix proportions under which equities may account for a half or more of portfolios.

Constraints

Besides fixing limits on the percentages of various classes of assets that may be included in pension funds, companies often impose a variety of other constraints on their investment managers. Table 2 provides details about two of these: banned investments and transactions.

Some corporate pension sponsors also establish limits on individual security purchases, durations of maturities, and requirements relating to the quality and marketability of acquired securities:

- Thirty responding sponsors forbid extensive accumulations of interests in individual companies. Seventeen of these limit holdings to no more than 5 percent of the outstanding shares; the remaining thirteen set upper limits of from 3 to 15 percent.
- Eight place lids on the percentage of fund assets that may be placed in a single industry; limits range from 12 to 50 percent, with a mode of 25 percent.
- Several sponsors confine maturities on fixed-income investments to periods of 10 years or less; a couple fix minimum maturities—five years, typically—for long-term fixed-income holdings. Two limit maturities of short-term fixed income securities to one year or less.

Ten survey participants require that bonds held in pension portfolios be of investment grade; seven specify that debt instruments with lower ratings are acceptable in moderate amounts for trust funds; six insist that prime or near prime ratings apply to all commercial paper holdings; and three demand that certificates of deposit and bankers' acceptances included among fund assets rely for credit-worthiness on well-capitalized or highly rated banks. A few insist that all securities in pension funds either be listed on major exchanges or possess other characteristics that ensure ready marketability.

[3] *Pension and Investment Age*, January 25, 1988, p. 13.

Table 2: Investment Constraints Imposed by Participating Companies

Prohibited Investments or Transactions	Number of Mentions
Securities of sponsors	27
Short sales	22
Margin purchases	16
Letter, unregistered, or restricted stock	12
Pledging or hypothecation	8
Options or futures*	8
Commodities	8
Puts, calls, straddles or hedges	8
Private placements	7
Securities of investment managers or trustees	6
Foreign securities*	5
Warrants	3
Real estate	3
Municipal or tax exempt securities	2
Other**	7
Total	142

* Exceptions permitted under certain conditions by several companies.
** Includes bans on repurchase agreements, offshore certificates of deposit, venture capital, commingled funds, indexing, and securities of companies headquartered in South Africa.

Other kinds of constraints are also encountered. Some surveyed companies insist that money managers have varying percentages of the funds committed to them invested in designated vehicles at all times. One, for example, sets a 90 percent minimum; another is more liberal, permitting its fixed-income managers the right to invest up to 50 percent of available funds in cash equivalents. Another demands that all fund purchases offer a minimum yield of two percent. And several limit the portion of total trust funds an individual investment manager may control: Maximum percentages in the 25 to 35 percent range are common.

Several sponsors set limits on the extent of foreign holdings in the equity portions of their portfolios; for example, two set tops of 20 and 25 percent respectively. Others set caps on the percentage of fund assets that can be invested in the securities of any individual overseas country. (One fixes a limit of 50 percent.) And a few insist that at least five or more markets (countries) be represented in international portfolios.

A couple of surveyed firms impose ranges for the minimum and maximum number of issues to be included in a portfolio—for example, no less than 25 but no more than 75 issues. Limits on investments by sector—holdings of utility, financial, or industrial securities, for instance—occasionally surface. One participant, for example, sets a ceiling of 50 percent for representation by any one sector. And a couple impose caps on commingled funds, closed-end bond funds, and private placements.

Not all participants place restraints on money managers, however. Some grant them discretionary authority to invest in the assets in which they specialize—equities, for example.

Such sponsors believe that leaving these professionals largely unfettered encourages better performance. The manager, trust investments, of a manufacturing company tells why its investment managers enjoy carte blanche:

> "We do not impose any constraints upon our investment managers. By way of explanation, we have a diverse group of managers, and each is largely a specialist who provides us with a unique style, philosophy, etc. Since they were retained for their established expertise in a specific area of investment, constraints would only serve to inhibit their ability to deliver the service for which they were retained."

Appraisal Approaches

Since many companies specify objectives for their pension funds in policy statements, they also include descriptions of how, and often at what intervals, accomplishments will be measured. Including such information helps to avert potential appraisal problems, such as disagreements on evaluation methods or the standards to be used (see box).

Other Instructions

Regulations concerning other major issues are also found in policy statements. Directives on the need to adhere to investment guidelines appear fairly often. Also popular are sections outlining reporting requirements, such as the following from a manufacturer's policy guidelines:

> Each investment manager is responsible for regular and open communication with the Company on all significant matters pertaining to investment policies, objectives, and the management of pension fund assets. This includes significant changes in investment outlook, investment approach, philosophy or strategy, asset allocation, portfolio risk, and market value of assets.
>
> The Company expects to be promptly informed of significant changes in the ownership, organization structure, financial condition, or senior personnel staffing of the investment management organization. Audited financial statements are to be furnished annually by each investment management organization....
>
> The Company recognizes that capital markets are dynamic and policy guidelines and investment objectives promulgated at one point in time may not always be totally appropriate, applicable, or meaningful. Whenever an investment manager believes that any particular guideline or objective is too broad or too restrictive, requires further definition, or should be altered or deleted, it is the responsibility of that manager to make appropriate recommendations to the Company.
>
> Each investment manager is to furnish data quarterly or monthly as appropriate:
>
> 1. To permit investment performance analysis;
> 2. To permit identification of investments showing costs, market price, maturity, etc.; and,
> 3. To review transactions during the period.

Other less frequently encountered policy instructions include directives on the conduct of securities transactions, diversification of assets in a given class, and the voting of proxies (subsequently discussed).

Performance Evaluation at a Utility

The following section on pension fund appraisals from the investment policy statement of a utility is representative:

"The *fund's performance* will be monitored monthly, reported on a quarterly basis, and evaluated relative to the performance of the various managed fund indices: the S&P 500 Index, the Lehman Brothers Kuhn Loeb Government/Corporate Bond Index, and the Salomon Brothers High Grade Corporate Bond Index.

"*Manager investment performance* will be monitored monthly and reported on a quarterly basis, and evaluated over a market cycle relative to the S&P 500 Index, the Lehman Brothers Kuhn Loeb Government/Corporate Bond Index, the Salomon Brothers High Grade Corporate Bond Index, and selected universes of managers of similar size and with comparable investment styles. Active managers will be expected to outperform relevant indices and be above the median of peer managers in the selected universe over a market cycle.

"The Retirement Committee should meet with each of the fund's managers at least once a year. The pension fund staff will meet with each of the fund's managers at least twice a year and report anything of significance to the Retirement Committee.

"Managers will also be evaluated in terms of compliance with ERISA and Company imposed investment guidelines, adherence to stated investment philosophy, and the timeliness and accuracy of the reports and other information provided to the company. Managers are required to notify the Retirement Committee of any major changes in philosophy or strategy and any changes in key personnel."

Money Management

Companies have three options in the management of pension funds; they can use external specialists, internal administrators, or both. As Table 3 on page 10 shows, participating sponsors lean very heavily on outsiders.

Companies that decide to rely on outside managers can choose among banks, investment counselors, insurance companies, venture capital partnerships, tactical asset allocation managers (see box on page 10), and others. The number of firms retained can vary from one to several dozen, depending on the needs of individual sponsors.

Where only a single external manager is employed, the absolute fund size is usually moderate. Satisfaction with per-

Table 3: Pension Fund Money Managers in 112 Participating Companies

Investment Managers	Percent Using
Outside experts	80
Internal staffs	3
Combinations of outside and internal managers	17
	100

formance over a period of years may also dissuade a sponsor from splitting funds among several managers.

When multiple money managers are engaged, prudence and diversification are often the key motivators. Sponsors of large funds may believe it unsound to concentrate holdings with one manager. Others seek to secure desired asset mixes by hiring several managers, each specializing in areas such as equities, bonds, or real estate, rather than relying on an individual manager who offers a balanced approach to investment.

Companies that opt for external management of pension assets offer a variety of reasons for their choice. Some simply lack the internal know-how investment administration demands. Others are unwilling to upset their salary structures by adding high-priced investment executives to the payroll. Still others find outside managers appropriate because the relatively small size of funds makes the addition of investment professionals to in-house staffs impractical. And, as mentioned, several sponsors view external management as a sound route to ensure variety in the composition of fund assets. A few also say external management facilitates change because it is easier to discharge outside managers than in-house employees.

Those favoring internal management generally have funds of sufficient size to justify staffing expenses. These do-it-yourself advocates find it less demanding to manage funds than to manage managers. They also maintain that because in-house managers serve only one master, they can focus their talents exclusively on doing well by that master and therefore produce superior results.

Sponsors relying on a mix of external and internal managers claim that combination of skills adds value. They think this approach helps to contain costs and hones the skills of in-house managers while permitting access to needed outside expertise. Comments the CFO of a participating utility that splits investment responsibilities between insiders and outsiders:

> "We believe that internal passive management is cost effective for a fund our size, and it also gives us flexibility in controlling asset mix, trading portfolios, making manager changes, or other restructuring. Active management requires specialized skills and is also people-intensive, and we believe that capability is best found externally."

Selecting External Managers

Selection criteria for outside investment managers are detailed in written form by a number of surveyed firms. Common standards include a prospective manager's history, staffing, and investment focus. Of course, particular attention is paid to the manager's performance record. A surveyed utility lists the following as critical selection guidelines:

> "Selection of managers should be consistent with ERISA, the trust agreement, and the pension fund's fundamental plan.
>
> "Arbitrary restrictions which rule out otherwise superior candidates should be avoided.
>
> "All aspects of the individual capabilities of the finalists should be researched in detail, on the prospective managers' premises if possible.
>
> "Consideration should be given to the following criteria when selecting a new manager:
>
> - Organization of the investment firm,
> - Performance results,
> - Personnel qualifications,
> - Investment philosophy,
> - Research capability,
> - Investment control and review process,
> - Investment capacity,
> - Investment strategy—short and long run,
> - Management fees, and
> - Compensation policy—implicit and explicit motivations."

Some sponsors launch probes for investment managers before openings actually exist. That way they are prepared to act quickly should the need to add or replace managers suddenly arise. Such sponsors, sometimes with the aid of

Tactical Asset-Allocation Managers

A limited number of firms offer a specialized investment approach to pension funds, referred to as tactical (or strategic) asset management. Tactical asset-allocation managers act on the belief that asset classes—stocks, bonds, and cash equivalents—become mispriced relative to one another from time to time and that taking advantage of these occasions can yield outstanding investment results.

Managed accounts are monitored closely and shifts in asset allocations are made in compliance with guidelines suggested by computer models. These models, or "deployment optimizers," direct adjustments in asset mixes in response to changing investment outlooks. Futures contracts rather than actual security holdings are sometimes employed to carry out the strategy because their use can save time and money.

One tactical asset allocation purveyor provides performance data indicating that the results produced by its method over three-, five-, and ten-year periods were considerably better than those recorded by the S&P 500 average. The manager also claims its model will permit clients to steer clear of disastrous years when the markets experience drops of 20 percent or so by directing funds to the safety of cash equivalent investments during such declines.

Table 4: Compensation of Money Managers by 86 Participating Companies

Method	Percent Using
Fee schedules	80
Negotiated arrangements	11
Performance based	9
	100

search organizations or databases compiled by consultants, contact potential replacements and arrange interviews. They also perform extensive quantitative analyses of the firms' records to confirm desirability. Here is how the CFO of a participating service company describes its selection process:

> "The staff maintains contact with many different investment managers. In addition to extensive manager files we also subscribe to the Plan Sponsor Network and various Evaluation Associates publications. When a new or different investment style has been identified as a potential addition to reduce the overall risk of the plan investments, managers that utilize the investment style are selected from the sources listed above. Once the managers have been selected, they are sent a questionnaire. After the questionnaires have been returned, the staff ranks the responses in a matrix for each question.
>
> "The matrix is then evaluated and a short list of managers is selected for further review. Meetings are then held with the remaining managers, either at their offices or at our offices. The matrix is then expanded to include rankings based on the additional information gathered from the meetings. The matrix is evaluated once more and the top two managers are usually selected for presentations to the Trust & Thrift Committee for final selection. After listening to presentations from the finalists, the Committee selects the manager to be added."

Compensation

As Table 4 indicates, 80 percent of surveyed pension fund sponsors pay money managers in accordance with schedules that usually call for payment as a percentage of assets under management, with the percentage ordinarily declining in stages as the amount involved rises. States the director, trust planning and administration, of a utility, "We compensate managers essentially through conventional fee arrangements, the [payment] range being from approximately 45 basis points to roughly 80 basis points [of managed funds], with the average being somewhere in the mid-to-high 50's." The accompanying box lists the fee schedules that apply to various managers of the pension fund assets of another responding company.

But other companies are trying different tactics. To control investment management costs, some sponsors are negotiating fees with managers. Others, perhaps to improve results as much as to control administrative outlays, are turning to performance-based compensation systems now that the Department of Labor sanctions such arrangements.[4]

[4]Prior to 1986, when the Department of Labor issued an opinion that permitted, subject to certain conditions, the use of incentive fee arrangements, performance based compensation programs for fund managers were not allowed.

Incentive-type fees usually have lower minimums than the approximately 0.5 percent charge that would normally apply under fixed-fee schedules. Additional payments in agreed amounts are made if managers' returns exceed those of preset targets, such as pertinent indices. These arrangements have been spurred by the events of recent years, which saw managers who failed to achieve even average results, as measured by indicators of market performance, receive substantial income hikes as assets under their management climbed sharply during the market's upward surge.

Will performance-based fees become a trend? Some sponsors are considering a move in this direction, but others are far from convinced of its wisdom, as witnesses the director, pension asset and liability management, of a manufacturing concern:

> "We have completed preliminary work on the topic of incentive fees, but have yet to conclude that this approach is in the best interest of the fund. We believe there are real questions about whether the managers might be inclined to take a different risk approach with assets managed on an incentive fee basis

Manager Fee Schedules--A Service Company

Manager of active convertible securities	0.5 %	first $25 million
	0.4 %	next $25 million
	0.25 %	over $50 million
Manager of active equity	0.75%	first $10 million
	0.625%	next $10 million
	0.5 %	next $20 million
	0.375%	next $20 million
	0.25 %	over $60 million
Manager of active intermediate fixed income	0.25 %	
Manager of active optioned equity	1.0 %	first $10 million
	0.75 %	next $ 5 million
	0.25 %	over $15 million
Manager of active fixed income	0.4 %	first $10 million
	0.2 %	over $10 million
Manager of active balanced	0.8 %	first $10 million
	0.6 %	next $10 million
	0.5 %	next $15 million
	0.4 %	over $25 million
Manager of active fixed income	0.375%	first $15 million
	0.25 %	next $15 million
	0.2 %	over $30 million
Manager of passive fixed income	0.15 %	first $30 million
	0.1 %	over $30 million
Manager of cash management	0.15 %	first $30 million
	0.125%	next $30 million
	0.1 %	next $40 million
	0.05 %	over $100 million
Manager of passive equity	0.12 %	

than they otherwise would, especially if they were to get significantly behind the performance necessary to earn a reasonable fee fairly early in the time frame for the incentive fee."

Evaluation

Manager evaluations are based on appraisal approaches, already discussed, that sponsors convey to managers at the time of engagement. At set intervals, sometimes as frequently as monthly but more often quarterly or semiannually, companies, many with the assistance of consultants, review the performance of money managers to determine if they complied with the sponsors investment guidelines and if investment results were favorable. Supplementing internal reviews, in-person meetings are usually held with investment managers, at least annually and sometimes more frequently, to discuss results, investment outlook, and other pertinent matters. While programs for these sessions vary, the following format set by a participating manufacturer is representative:

"The investment managers will be expected to meet with the company periodically to review the investment outlook, structure of their portfolios, and past results. A general agenda for these meetings should include (but is not limited to):

- A review of the investment results achieved over the prior quarter and year in relation to a manager's investment views and internal policies in effect prior to, and during, the period;
- An examination of the manager's current outlook for the economy and capital markets over the next six to 12 months;
- A discussion of the [manager's] investment policies that have been adopted in response to these expectations;
- An analysis of the appropriateness of the present portfolio under management, given the expectations and internal policy; and
- A review of the [sponsor's] guidelines relative to any restraints that [the guidelines] may represent relative to a manager's ability to fully reflect his organization's expectations or policy."

What happens as a result of appraisals? Excellent performers may be rewarded with additional funds—from contributions or transfers—to invest. Underachievers are usually admonished and urged to improve their performance. Failure to do so, as the following policy statement makes clear, can result in a manager's removal:

"The pension fund staff will immediately notify the manager or trustee of any perceived deviations from the expected level of performance. The performance shortfall will be discussed and reviewed periodically with the manager or trustee. If, after a manager or trustee has had reasonable time to correct any deviation from expected performance levels, it is determined that sufficient progress toward correcting faulty performance has not been made, the Retirement Committee shall proceed with the steps necessary to alter the responsibilities of that manager or trustee, inclusive of dismissal."

In most cases dismissal does not take place until the money manager has been given sufficient opportunity for improvement, perhaps for a period of at least several years. But on occasion removal occurs sooner and not always based on producing less-than-expected returns. One participating company listed eight possibilities for reducing assets under management or firing money managers: (1) inability to attain investment goals; (2) variations in investment strategy; (3) failure to implement stated policy; (4) "closet indexing" while receiving an active management fee; (5) ineffectual handling of rapid growth of assets under management; (6) loss of key staff members; (7) general inconsistency or laxity; and (8) lack of conformity with prescribed guidelines.

Opting for Active or Passive Management

In addition to deciding whether to manage pension funds internally, to associate with outsiders, or to assign the task totally to external experts, companies with pension plans have to choose between active and passive management styles for their funds. Until about 15 years ago, the passive option did not exist; all funds were placed in the hands of active managers who sought to produce superior results by bringing their investment skills—in stock picking or market timing, for example—to bear. But as the efficient market theory, which holds that market prices at any given time reflect all that is knowable about securities, gained adherents, many investors concluded that securing better-than-average performance was both difficult and risky. As a result, some managers adopted the goal of equaling market results for at least a portion of their funds.

To match market performance, companies ordinarily put varying amounts of their assets into index funds—funds modeled after the Shearson Lehman Brothers Corporate/Government Bond Index, the S&P 500 Index, or other selected indicators. Available sampling techniques make it possible to obtain much the same outcomes without including in the pension fund portfolio all the securities covered by a particular index.

In addition to ensuring returns comparable to those realized by the market as a whole, indexing holds out other inducements. It gives sponsors a readily available substitute for poorly performing active managers, provides an easy route to diversification, and facilitates hedging. Also, because it usually involves little trading of holdings, indexing offers both lower transaction costs and management fees than those for funds requiring ongoing active supervision. By the fall of 1987, passive investing through index funds had attracted some $200 billion in pension assets, split about three parts equity to one part fixed income.[5]

[5] *Business Week*, September 21, 1987, p. 104.

Future Indexing Trends

Almost two-thirds of respondents do not plan to increase reliance on passive management anytime soon (Table 5). Some of these oppose indexing as entirely too defensive or believe that active management is the better way to build their funds. Still other sponsors believe that present commitments to index funds constitute proper levels, which will be maintained. A few, anticipating slippage in economic conditions, intend to confine passively managed funds to present levels out of the conviction that active management may produce better results during down markets. And others think that more neglected segments of the market are best exploited by active managers. Observes a senior financial executive of this persuasion:

> "We believe the most effective universe for passive management is one that is most efficiently priced, and we think the most efficiently priced common stocks are large ones, such as those that dominate the Standard & Poors 500 Index, for example. We think smaller stocks are less efficiently priced and therefore are best actively managed, if one has managers in whom one has confidence. Partly because large stocks have so sharply outperformed small ones over the last four years, we feel generally that smaller stocks are currently more attractive, and this leads us toward more active management."

Among the study participants planning to boost their reliance on passive management, the increasing emphasis on indexing reflects a growing conviction that not only are active managers seldom capable of consistently doing better than the averages, but also that they charge more for delivering less. The manager of pensions of a manufacturer that recently significantly expanded its reliance on passive management techniques provides this rationale:

> "This decision was based on [the company's] very long investment time horizon—attributable to the demographics of our employee base—and the clear difficulties active managers have experienced in outperforming broad market indexes over such time periods. In addition, our strategic commitment to equities as an asset class is significant (70-80 percent), and we prefer not to bear the incremental risk and volatility associated with active equity management."

Of the companies that are unsure whether their use of indexing will increase, some are presently reviewing the pros and cons of upping their dependence. Others are deferring moves until they are better able to gauge the merits of existing active managers.

Table 5: Passive Management Trends Among 95 Participating Companies

Expectations on Indexing Usage	Percent
No increase anticipated	64
Increase expected	23
Uncertain	11
Decline expected	2
	100

Vexing Issues

While debate continues over the cause celebre of October 19, 1987, it also extends to a number of other important issues bearing on pension activities. For example, controversy swirls about the pluses and minuses of portfolio insurance; the ways in which pension funds cast votes as stockholders; the influence of institutional shareowners, and the utilization of reversions.

Portfolio Insurance

Portfolio insurance is not insurance in the ordinary sense, that is, it does not provide protection from loss in return for payment of a premium. Rather it is a computer-executed investment strategy designed to permit users to limit losses in down markets but still reap a good measure of appreciation in bull markets.

How does portfolio insurance, or dynamic hedging, as it is sometimes called, work? Basically suppliers of portfolio insurance, including a number of large banks and investment companies, hedge portfolios of stocks for users. In up markets, hedging is little used and sponsors enjoy capital gains. But in down markets, providers, in accordance with preset formulas, sell either stocks, or, more usually, futures contracts on stock indexes such as the S&P 500 because that is easier and less expensive.[6] Both the portfolio and futures contracts decline in value as the market falls. So when futures contracts are closed out, the price is lower than that obtained from their sale. The difference (or gain) on the futures transaction offsets the loss incurred on the stock portfolio.

Because of debate over the part it played in the stock market debacle of late 1987, portfolio insurance has been much in the news.[7] As one form of program trading, it is said by some to interact with another, index arbitrage, to the detriment of the stock market. For example, a portfolio insurer in reaction to market erosion might sell futures. Heavy selling would tend to push future prices down inducing arbitrageurs anxious to profit from price differentials to purchase "cheap" futures and sell "expensive" underlying stocks. This process, according to detractors, sets off vicious cycles, which can produce sharp declines in the actual market values of shares.

But portfolio insurers refuse to shoulder the blame for the recent stock plunge. They maintain that dynamic hedging worked, albeit not perfectly given chaotic trading conditions, in reducing client exposure to a falling stock market. Even so, use of portfolio insurance has declined since Black Monday. Table 6 on page 14 shows that only a small minority of surveyed companies presently rely on it.

[6]For a discussion of one role of futures in controlling risk see Melissa A. Berman, *Futures and Options For Hedging Corporate Debt*, Conference Board Research Bulletin 216, 1987.

[7]See, for example, Mark Rubenstein, "Portfolio Insurance and the Market Crash," *Financial Analysts Journal*, January-February 1988, pp. 38-47.

Table 6: Portfolio Insurance Usage Among 113 Participating Companies

Usage	Percent
Not employed	84
Active application	13
Discontinued	3
	100

Many nonusers of portfolio insurance mention the expenses entailed and doubts about the effectiveness of such programs as reasons for abstaining. The CFO of a manufacturer, for instance, fears that "dynamic hedging might be subject to execution risk. This does not mean that we are against hedging or other executable risk-control strategies, but rather that 'automatic' approaches are questionable."

Echoing this view, the treasurer of a service company states: "We had concluded prior to October 19 that there was more risk than insurance in this program should the market experience a violent decline, even though purveyors of this service assured us the program could cope under such conditions." Similarly the vice president, planning investment and development, of a manufacturing firm concludes that portfolio insurance will not be used "because of its cost in a volatile market and uncertainty as to how it would actually perform in a bear market."

However, some surveyed sponsors who indicate they do not use ordinary portfolio insurance to hedge against loss do in fact take comparable steps to protect pension fund assets. For example, the assistant treasurer of a manufacturing company explains how it attempts to shield its funds from heavy losses:

> "If you accept as a definition of portfolio insurance 'the forgoing of an acceptable amount of return in exchange for a preferred pattern of risk,' then we use portfolio insurance. Unlike conventional programs, however, we use the . . . allocation model to adjust stock market exposure well in advance of upturns and declines. By contrast the conventional programs await the onset of an upturn or a decline before adjusting exposure."

Other responding companies also rely on portfolio mix adjustments and hedging arrangements of various kinds to temper the impact of market declines on pension funds. One pension executive suggested an informal portfolio insurance approach based on the Dow Jones Industrial Average (DJIA). It calls for 100 percent investment in common stocks with the DJIA at 1000, 50 percent investment in common stock with the DJIA at 2000, and 0 percent in common stock with the DJIA at 3000. Appropriate adjustments would be made at other selected average levels—25 percent investment in common stock with the DJIA at 2500, for example—and targets might be reset periodically, perhaps at the end of market cycles.

Sponsors that use portfolio insurance are often risk averse and anxious to limit losses. Programs can be tailor-made to meet the needs of individual organizations. For example, one manufacturer's arrangement covers two years and is expected to protect the company completely from loss. Another's calls for the dynamic hedging strategy to "achieve a return equal to 85 percent of the S&P 500s return during bull markets and limit losses to five percent of the fund's [value] during bear markets."

A few participants discontinued the use of portfolio insurance. Two abandoned the program following the 1987 market crash because what they wished to guard against—an overvalued stock market—was no longer threatening, in their view. Another just thought it an unnecessary means of protecting the pension fund's surplus.

Voting Proxies

With stock investment goes the option of voting on many matters of vital concern to corporate managements as well as outside interests. At the present time pension funds are estimated to hold more than one fifth of the shares issued by domestic public companies. This already substantial ownership interest is expected to rise in the years ahead, which would increase its already considerable influence on the outcome of votes including, for example, those on takeover attempts.

Who votes the shares held by pension funds? Most participants in this survey delegate the responsibility to investment managers and trustees, as Table 7 indicates.

Voting Instructions

Many sponsors simply assign voting responsibilities to outside managers, giving them complete discretion to cast proxies as they see fit. Some provide minimal direction, advising managers simply to act in the best interests of plan participants. But even under such general guidelines companies may occasionally become involved directly in the voting of proxies, as the policy and practice of a participating manufacturer indicate:

> "It is the policy of the company that all securities held in the Pension and Profit Sharing Collective Investment Fund ("Collective Investment Fund") shall be voted in the best interest of the plan's participants, taking into consideration the possibility of a long-term investment by the Collective Investment Fund. To help ensure the attainment of this objective, the company may become involved in the voting of such shares in the appropriate case. In such instances the following procedures will apply:
>
> 1. The Trustee receives proxies, signs proxies, votes, and mails proxies directly *unless* issues to be voted upon may in the

Table 7: Voting of Pension Fund Proxies by 117 Participating Companies

Voting Responsibility	Percent
Investment managers	75
Trustees	20
Sponsors' management	5
	100

Trustee's opinion significantly affect shareholder value. Issues of this type include, but are not limited to:

- Significant acquisitions, and/or takeovers, or the avoidance thereof.
- Significant alterations to the capital structure.

2. If a proxy involves special issues affecting shareholder value as indicated above, the Trustee will forward a letter to members of management, or their successors, with the following information:

- Description of issue(s).
- Management's proposal on vote and the reasons therefore.
- Due date of proxy.

3. Members of management, or their successors, will decide how the proxy should be voted. The CFO, or his successor, will transmit voting direction in writing to Trustee.

4. The Trustee acting on the direction of the Company will vote the proxy and mail the form."

Other surveyed companies delegate voting responsibilities to managers or trustees, but include one or more constraints on their freedom. For instance, a few reserve the right to review, consult, or override on votes involving controversial issues. And almost a score suggest favoring the positions of management or advising the sponsor before voting in adverserial fashion. The following instruction issued by a manufacturer is illustrative:

"Trustee receives proxies, signs proxies in blank, and forwards proxies for voting purposes to the appropriate investment manager.

"Investment manager receives, votes and returns signed proxies to the issuer unless he intends to vote contrary to management recommendations. In such a case, when he intends to vote contrary to management recommendations, the investment manager forwards a letter containing the following information to the Company's Corporate Secretary:

a) The identity of the investment and the interest held;
b) The issues involved which may significantly jeopardize shareholder value;
c) The reasons he intends to vote contrary to management recommendations; and
d) The due date of the proxy.

"The Company's Corporate Secretary, upon advice of appropriate corporate officers, transmits voting instructions to the investment manager. Investment manager, acting upon the Company's advice, votes and returns the proxy to the issuer."

A handful of survey respondents prepare detailed proxy voting guidelines for investment managers. These may not only indicate matters that managers may routinely approve or refer to sponsors, but also contain detailed instructions on how to cast proxies on such matters as corporate governance, compensation and social responsibility. The box on pages 16-17 contains an example.

Of course, a speech by the Assistant Secretary of Labor on February 17, 1988 to a shareholder group together with a widely publicized letter of February 23, 1988 from the Deputy Assistant Secretary of the U.S. Labor Department to a corporate pension fund sponsor may prompt some companies to reassess their positions on the voting of proxies. These pronouncements make it clear that in voting pension fund shares fiduciaries must focus on economic values for plan beneficiaries and not be swayed by outside pressures.

Handling Solicitations

For the most part solicitations from companies whose shares are owned by a sponsor's pension fund are handled routinely. Often, contacted sponsors take time to advise inquirers on proxy voting methods; some even put them in touch with appropriate investment managers or trustees. The following reaction described by the manager, retirement funds management, of a participant is typical:

"We explain to senior executives of other companies that our policy is for the investment manager to vote these shares. We give them the name and phone number of a senior executive at the money management firm that is responsible for voting proxies and suggest that they give him/her a call."

Others just pass requests along to managers or ignore them. But some recipients are attentive to inquirers; they handle them on a case-by-case basis, devoting as much time and attention to each as appears appropriate. And a few consider requests and offer suggestions on the voting of proxies to managers.

Institutional Shareholder Influence

Because of their substantial interests, institutional investors, such as pension and mutual funds, have long been able to wield influence over the affairs of corporations in which they invest. But until fairly recently this power was seldom exercised, as these investors chose to refrain from interfering in management activities, even when disconcerted by the course of events. Rather than voice displeasure and work for change, they simply sold their shares and sought greener pastures.

But this is seldom the case today. Institutional investors are no longer hesitant about voicing opinions and attempting to direct management activities. Why this change? A combination of events helps to explain the increased activism. Some institutional investors undoubtedly felt threatened by the anti-takeover resolutions offered by companies in which they held shares. Others believed selling shares to resolve their differences with management was becoming ineffective since it entailed heavy pressures on markets and produced lower prices. Still others became convinced that influencing the activities of companies in which they held shares was a neglected responsibility. In addition, the formation of discussion groups among institutional investors, especially public pension funds, encouraged the pursuit of shareholder rights.

Aware of the efforts of institutional investors to sway the outcome of certain issues requiring stockholder approval, the managements of some companies undertook countermeasures. Some contacted their own pension managers and

Proxy Voting Guidelines of a Manufacturer

To provide directions to its various investment managers on the voting of proxies, the Company from time to time furnishes instructions such as those below.

"The Manager, Corporate Investments has delegated authority to the investment managers to vote security proxies in accordance with the guidelines outlined below.

"In voting proxies, investment managers are expected to take positions which safeguard and promote the interests of the plan beneficiaries, and which advance the economic values of the companies whose securities are held. Companies selected for investment will generally have management teams which operate in the best interests of shareholders, and proxies will therefore tend to be voted with management. However, there may be exceptions to this from time to time where it might not be appropriate to vote proxies with management. Any vote that would be regarded as a vote against management is to be referred to the Manager, Corporate Investments for review by the Company's Investment Committee. Actions of the investment managers as well as instructions given to them by the Manager, Corporate Investments will be reported to the Investment Committee on a regular basis.

"Investment managers may vote to:

1. Approve annual election of directors and appointment of outside public accountants.

2. Approve stock incentive programs as long as they produce management incentives in parallel with the long-term interest of shareholders and do not represent excessive dilution of equity; excessive dilution is defined as more than one percent annual increase of total shares outstanding for companies having market capitalizations over $300 million.

3. Approve external shareholder requests unless they are not in the best interests of long-term investment by the Employee Benefit Funds.

"The following proxy issues need to be reviewed with the Investment Committee before approval:

1. Issues that significantly affect the long-term economic value of the holding, such as:

   a. Significant dilution of shareholder equity (e.g., anti-takeover provisions which allow over 5 percent dilution from new equity issuances to employees/directors, or 10 percent dilution from new external issuances).

   b. Acquisition or change of corporate structure that could change the economic value of the investment significantly.

   c. Implementation of discretionary capital structuring to produce 'shark repellent/poison pill' or other shareholder changes.

2. Social issues such as those regarding companies with operations in South Africa.

"Voting guidelines that address these and other issues in more detail will be supplied to the investment managers at the beginning of each proxy season, as appropriate. A copy of the current Voting Guidelines follows.

"Proxy issues should be considered on a case-by-case basis. If an Investment Manager believes that the following guidelines are inappropriate in a particular case, the issue should be referred to the Manager, Corporate Investments for review. All issues noted 'Refer' should be submitted to the Manager, Corporate Investments for review.

ROUTINE MANAGEMENT PROPOSALS	(GUIDELINE)
• Annual election of directors and outside public accountants	APPROVE
• Establishment of employee stock ownership plan	APPROVE
• Establishment of 401(k) plan	APPROVE
• Elimination of preemptive rights	APPROVE
• Increase of authorized common	APPROVE

• Increase of authorized preferred (nonvoting or one vote/share)	APPROVE
• Limitation of directors' liability under various state laws	APPROVE
• Indemnification of directors and officers	APPROVE

ANTI-TAKEOVER PROPOSALS

Corporate Governance	
• Establishment of classified board/staggered terms	APPROVE
• Requirement of more than 2/3 vote to remove directors	REFER
• Requirement of more than 2/3 vote to amend or repeal By-Laws/Articles of Incorporation	REFER
• Restriction of shareholders' right to call special meeting	REFER
• Prohibition of shareholder action outside meetings	REFER
• Establishment of anti-greenmail provision	APPROVE
Other Anti-Takeover	
• Requirement of more than 2/3 vote to approve merger, sale, etc.	REFER
• Fair price in two-tier offers	
-Same price and form of consideration	APPROVE
-Tied to book value, acquirer's p/e, etc.	OPPOSE
• Defenses which could negatively affect the economic value of the investment significantly (e.g., "Crown Jewel", "Scorched Earth", "Poison Pill")	REFER
• "Blank Check" Preferred	
- Stand-alone proposal, few or no other anti-takeover measures on books	APPROVE
- Part of a package, or other restrictive measures already on books	REFER
• Differential voting power	REFER
Authorize a class of common having superior voting rights over the existing common, or entitled to elect a majority of the board of directors	

MANAGEMENT COMPENSATION

• Stock incentive programs that produce management incentives in parallel with the long-term interest of shareholders and do not represent excessive dilution of equity. (Excessive dilution is defined as more than one percent annual increase in total shares outstanding for companies having market capitalizations over $300 million)	APPROVE
• Exchange outstanding options/warrants for new ones with lower exercise prices	REFER
• Incentive compensation	
No limit on payments	OPPOSE
Very few participants	OPPOSE
Not tied to long-term value of company	OPPOSE

INCREASE IN AUTHORIZED SHARES

• Authorization of additional share capital which could create dilution of over 10 percent (5 percent for employee stock incentive programs) over five or fewer years	REFER

ENVIRONMENT/SOCIAL RESPONSIBILITY

Serious proposals on these matters should be referred to the Manager, Corporate Investments for review."

senior executives of other companies with pension funds to seek support for their proposals.

Of course, these developments preceded the recent Department of Labor initiatives, discussed on page 15, on the voting of pension fund shares. Whether these directives will ameliorate or exacerbate the rifts over proxy resolutions between companies and institutional investors remains to be seen. But there is little gainsaying that institutional investors are a force to be reckoned with now and even more so in the future, as their hold on corporate share ownership continues to expand.

Reversions

Under provisions of ERISA, the residual assets of a pension fund may revert to the fund's sponsor provided the obligations of the plan the fund financed have been satisfied. Since 1980, when the trend got underway, reversions have returned over $13 billion to corporate coffers. While the pace of reversions has slowed somewhat of late, due largely to capital market and tax developments, the possibility of a resurgence remains, especially if supportive measures are implemented.

The Tax Reform Act of 1986 imposed a 10 percent excise tax on reversions. This, in addition to ordinary income tax, served to put a damper on the activity. But under a Reagan Administration proposal, which would also strengthen safeguards, sponsors would be permitted to transfer assets eligible for reversion to a fund for retiree health care. Such transfers would be exempt from both income and excise taxes.

Opponents of reversions generally believe they serve to undermine the soundness of private pension plans by whittling away its underpinnings. The fact that plan beneficiaries have little or nothing to say about such moves also irritates them. Supporters, on the other hand, claim reversions merely represent recapture of funds needlessly donated, and that efforts to interfere with the process will only hamper further progress in the private pension system.

Disagreement (as well as litigation) over the course and effects of reversions continues. Indeed, recently, lack of resolution on the issues involved prompted Senator Howard Metzenbaum (Dem., Ohio) to introduce a bill proposing a moratorium until October 1989 on the return of residual plan assets to sponsors.

Future Investing Approaches

What kinds of investments will find favor with pension fund sponsors during the next five years? Presently unforeseen developments—of an economic or regulatory nature, for example—will probably influence choices. Meanwhile, Table 8 on pension fund investment plans by surveyed companies provides clues about the vehicles of choice over the next five years.

Table 8: Contemplated Changes in Investments by Participants During Next 5 Years

Investment Approach Change Planned	Number of Mentions
No major change planned	41
Expand holdings of international securities	35
Increase venture capital commitments	22
Add to real estate investments	22
Increase fixed income commitments	10
Add to alternative investments	10
Decrease Guaranteed Income (Investment) Contract (GICs) holdings	4
Expand holdings of private placements	2
Opportunistic approach: depends on developments	5
Other	2
Total	153

Many companies anticipate little in the way of investment innovation. "No significant changes are planned," says the executive vice president—finance of such a concern. "We will continue to use both traditional and nontraditional investments and to adjust the allocation of assets among the various classes when deemed appropriate."

But others, to revamp their holdings further or to improve results, expect to expand their use of certain investment approaches. Especially well liked by members of this group are investments in international securities, venture capital undertakings, and real estate projects. All three have appeal to some as the words of one pension officer attest: "I think there is a fairly good chance over the next five years that we will be diversifying into international equities and also into real estate investments which we heretofore have not used. In addition, it is fairly likely that we will increase slightly our allocation to venture capital, which currently represents less than one percent of the fund's assets."

Despite their popularity, these investment vehicles are not without detractors. For example, the manager, pension plan coordination, of another sponsor expresses reservations about international and venture capital commitments:

> "We continue to monitor potential investment alternatives for our pension assets. For example, we have looked into international diversification; however, the strong interplay between the world equity markets puts into question the value of this type of diversification. A further drawback to international investing on a broad scale is the lack of liquidity and the complete market shutdowns that occurred in many of the smaller, less mature markets on Black Monday, October 19.
>
> "Venture capital investments have also been a hot area in pension fund investing in recent years. However, a number of larger investors have been reducing their exposure as the economy slows. In our mind, venture capital investments represent a means for an organization to acquire technology, or exposure, to new businesses. A successful venture capital investor must become a partner to the business, understanding the general

Asset-Liability Matching

Why has asset-liability matching come to the fore as a consideration in investing pension funds?

FASB 87, Employers' Accounting for Pensions, the statement that now controls how companies account for pension activities, unintentionally bears a measure of responsibility. The statement includes the requirement that liabilities as well as assets of pension funds be determined annually on the basis of fair market value. In addition, FASB 87 requires that, commencing 1989, liabilities be recognized on balance sheets when accumulated benefit obligations exceed the value of plan assets. Since calculating market value involves the use of current interest rates and these are subject to wide swings, the possibility of stating net pension obligations as liabilities is very real.

To maintain surpluses, control expense volatility, and thereby find refuge from the possibly bothersome effects of FASB 87, some sponsors are considering the revision of existing investment strategies. Several interviewed executives considered putting greater emphasis on fixed-income securities in their portfolios but found this unnecessary in light of existing surpluses. But others are weighing the possibility of switching to bond portfolios whose sensitivity to interest rate changes parallels that of the funds' liabilities.

Some question the wisdom of a strategy matching assets with liabilitie because it places accounting concerns above economic considerations. To deal with this perceived shortcoming, some companies may attempt other tacks, including lengthening the duration, but not the amount, of their fixed-income holdings; expanding bond investments without eliminating stock investments; and employing surplus insurance (an offshoot of portfolio insurance), which maintains desired relationships between pension fund assets and liabilities—for example, by acquiring stock in rising markets and withdrawing into fixed-income securities in falling markets.

and sector economic outlooks, as well as take an active role in the management and administration of the business plan. We believe this responsibility is well beyond our role in pension management, and presents unknowns and opportunity for loss inappropriate for pension funds.

"A newer development in this arena that may make venture investments a more viable alternative are venture funds that build portfolios of venture capital investments. However, even these investments will prove to be highly volatile compared with the market."

And the manager of benefit plan assets for a utility expresses concern about real estate investments:

> "The one new investment vehicle in which we may commit some of our plan's assets over the next five years would be real estate. However, our concern over current market conditions in the real estate sector and the significant structural changes occurring in the real estate market due to the increasing institutionalization of the market make me hesitant to predict an investment by our plan in this area over the next several years. With minor exceptions, our assets are currently invested 100 percent in domestic equities and domestic fixed-income securities. My best guess is that this will be unchanged five years from now."

Those surveyed companies intending to add to their fixed-income investments hope either to take advantage of attractive yields or to structure arrangements designed to address concerns on asset-liability matching (see box). Others plan to expand alternative investments, especially commitments to leveraged buyouts and oil and gas properties. Some will take an opportunistic approach, monitoring various markets to take advantage of attractive situations as they arise. Several will reduce holdings of guaranteed income contracts (GIC's) but one will expand such holdings. And a couple intend to increase commitments to private investments.

Appendix

This appendix contains investment guidelines for money managers issued by participating pension fund sponsors. Exhibits 1-3 provide directives on fixed-income portfolios. Policies covering equity investments are found in Exhibits 4-7. Instructions on international securities are the focus of Exhibits 8-9. Guidelines on the investment management of oil and gas, real estate, and cash reserve funds follow (Exhibits 10-12). And the concluding Exhibits, 13-15, provide illustrations of guidelines issued to balanced account managers.

Exhibit 1: Performance Standards for Fixed-Income Investments—A Manufacturing Company

1. Over periods less than a market cycle, provide total rates of return in excess of the median of a universe of managed fixed income funds.

2. Over a full market cycle (roughly a four-year period), add value to the portfolio to the extent that the annual return exceeds that which could be obtained from a static position of 100% of the fund invested in the Shearson Lehman American Express Government/Corporate Bond Index by 100—200 basis points per year or more. This value should be added through one or both of the following decisions:

   a) selection decisions, i.e., the selection of securities that outperform the Shearson Lehman American Express Government/Corporate Bond Index;

   b) duration decisions, i.e., opportunistically adjusting the duration of the portfolio in anticipation of interest rate shifts.

3. Over the longer term (i.e., period longer than a market cycle), provide a total rate of return premium of 3.5% over the inflation rate (as measured by the CPI).

4. Over a market cycle and longer, maintain the volatility of the total rate of return at a level equal to or below that of the Shearson Lehman American Express Government/Corporate Bond Index.

Exhibit 2: Investment Guidelines for Fixed-Income Managers—A Manufacturing Company

Within the parameters of prudent risk, your overall objectives as a fixed income investment manager of a portion of the company's Employee Benefit Funds are listed below in the order of priority:

- Preservation of Capital
- Long-run Rate of Return

The specific performance goals against which you will be measured are that as a fixed income manager, it is expected that you will achieve a minimum return of 105% of the Shearson Lehman Government/Corporate Bond Index (Kuhn Loeb) over a 3 year cycle.

A rating by Moody's Investment Service, Standard & Poor's Corporation or Fitch Investors Service, Inc. of Grade A or higher is required for long-term fixed income securities except as noted below. No investment shall be made in any such security that is classified by any of said services as less than Grade A with the following exceptions:

(1) You are authorized to invest in debt instruments with credit ratings below the "A" standard for bonds up to a maximum amount of 30% of the fixed income portion of the total portfolio. Selection of individual bonds, and the percent to be invested therein, is solely within your discretion.

(2) Commingled or pooled funds containing long-term fixed income securities rated less than "A" are acceptable if the total market value of such securities and any less than "A" rated securities not included in the pool, when combined, do not exceed the 30% limitation.

For short-term investments, obligations issued or guaranteed by the U.S. Government or any Agencies thereof are acceptable together with commercial paper rated A-1 by Standard & Poor's Corporation or P-1 by Moody's Investment Service and Master Notes with corporations holding commercial paper ratings of A-1 or P-1.

Also acceptable are Domestic CD's, London Eurodollar CD's, London Time Deposits, CD's of U.S. branches of foreign banks (known as Yankee CD's) and Bankers' Acceptances guaranteed by U.S. banks that are generally among the fifty-five largest and selected prime foreign banks. These instruments must be rated above "C" by Keefe, Bruyette and Woods and must be monitored by an organization's credit and equity analysts as to quality. London Eurodollar CD's, London Time Deposits and Yankee CD's are acceptable for commingled short-term investment funds only and such instruments may not exceed 20% of the commingled fund size.

In constructing a short-term portfolio of the various investment vehicles discussed, limits are to be placed on the amounts to be invested in each type of instrument. Repurchase agreements must be adequately collateralized by obligations of the U.S. Government or its Agencies. Maturities may in no event exceed fifteen months and prudent standards of liquidity and credit quality must be maintained.

No part of the fund shall be invested in any security issued or guaranteed by (the sponsor) or any of its subsidiaries. Commingled or pooled funds containing securities issued or guaranteed by (the sponsor) or any of its subsidiaries are acceptable if the total market value of such securities is less than 10% of the market value of the total commingled or pooled fund.

The attached list of all of the Investment Managers and the Trustees is provided for your information in order that you may comply with the Articles of the Employee Retirement Income Security Act relating to prohibited transactions.

You are required to provide the (sponsor's) Pension Fund Trust and Investment Committee with a comprehensive written statement, in advance, of any major change in your investment and portfolio strategy.

For the purpose of monitoring your overall performance, as required by ERISA, the Committee will utilize the annual and quarterly accounts of the Trustee and such additional reports and information as you are required to furnish pursuant to the provisions of your Investment Management Agreement.

These investment guidelines supersede all previous guidelines and instructions regarding the investment of (the sponsor's) Employee Benefit Funds. The Committee reserves the right to revise the guidelines in the future as conditions may require.

Exhibit 3: Investment Guidelines for Short-Term Bond Managers—A Manufacturing Company

A. Objectives

1. As an active bond manager: By employing a disciplined fundamental investment approach that utilizes maturity restructuring, yield curve strategies, and sector and credit risk analyses, to select fixed income securities with superior financial characteristics.

2. To achieve an average annual compound portfolio return over any two to four year period, net of all fees and expenses, significantly above the comparable return of a custom index derived by averaging, on an unweighted basis, the annual returns of the Salomon Corporate three to seven year bond index and the Salomon Treasury/Agency one to ten year bond index. The Investment Committee assumes that achievement of this objective would place the investment manager's performance significantly above the median performance of bond managers who invest in short-term securities.

B. Guidelines

1. Fixed income securities with maturities less than one year (cash instruments) are permitted, but at no time should the portfolio's average maturity, including cash instruments, fall below two years. The portfolio's average maturity should normally range between three and five years.

2. Each long-term fixed income security selected must be of investment grade (BBB or better if rated by S&P; Baa or better if rated by Moody's).

3. No single long-term corporate issue rated AA or AAA should exceed 10% of the portfolio for an extended period without the prior consent of the Investment Committee.

4. No single long-term corporate issue rated BBB or A should exceed the greater of $500,000 or 5% of the portfolio for an extended period without the prior consent of the Investment Committee.

5. No more than 50% of the portfolio should be invested in any one bond sector (i.e., industrial, financial or utility). This limitation does not apply to securities of the U.S. government or U.S. governmental agencies, or to cash instruments.

6. The following limitations shall apply to cash instruments:

   a. Investments in obligations of the U.S. government, U.S. governmental agencies or in (a bank's) short-term money market fund may be made without limitation (except for Guideline 1's limitation).

   b. Investments in commercial paper should be limited to issuers whose paper is rated A-1+, A-1, and/or P-1. Investments in any one issuer's paper should not exceed the greater of $1 million or 5% of the portfolio.

   c. Investments in negotiable certificates of deposit and bankers' acceptances should be restricted to those U.S. banks judged by (the investment manager) to be of unquestioned credit strength and quality (normally the 50 largest, ranked by assets, plus certain large regional banks). Investment in any one bank's obligations should not exceed 5% of the portfolio.

7. Investments in publicly traded closed-ended bond funds are permitted but should not exceed 15% of the portfolio without the prior consent of the Investment Committee.

8. All investments are to be in U.S. dollar-denominated securities. No more than 25% of the portfolio should be invested in securities issued or guaranteed by foreign entities.

9. Excessive turnover (i.e., turnover rates that are unusually high relative to the manager's historical experience and investment style) should be avoided.

10. The Investment Committee should be advised promptly if any of the following events occur:

    - a significant change in investment philosophy
    - a loss of one or more key people
    - a new portfolio manager(s) on the (sponsor's) account
    - any event that is likely to adversely impact to a significant degree the management, professionalism, integrity or financial position of (the investment manager)

Exhibit 4: Performance Standards for a Core Equity Manager—A Manufacturing Company

1. Over periods less than a market cycle, provide total rates of return in excess of the median of a universe of managed equity funds.

2. Over a full market cycle (roughly a four-year period), add value to the portfolio to the extent that the annual return exceeds that which could be obtained from a static position of 100% of the funds invested in the S&P 500 by 200 basis points per year or more. This value should be added through one or both of the following decisions:

   a) selection decisions, i.e., the selection of securities that outperform the S&P 500;

   b) allocation decisions, i.e., opportunistically adjusting the equity exposure level (equity and cash allocation).

3. Over the longer term (i.e., periods longer than a market cycle), provide a total rate of return premium of 6% over the inflation rate (as measured by the CPI).

4. Over a market cycle and longer, maintain the volatility of the total rate of return at a level equal to or below that of the S&P 500.

Exhibit 5: Objectives for an Equity Manager—A Manufacturing Company

Mainly because of large holdings of fully participating annuities, we do not expect any substantial benefit payouts will have to be made from the (sponsor's trust fund) for quite some years. We therefore feel we can undertake the normal risk—and opportunity—of equity markets on this entire trust fund and still maintain a prudent balance in our overall pension assets.

Our objective for your account is that you build the highest long-term rate of total return that you can relative to equity markets. We shall monitor your results on a continuing basis and evaluate them in comparison with the total return on the Wilshire 5000 (capitalization weighted). Our judgements are based mainly on a time horizon of three to five years.

Your account will at no time exceed 10% of the total assets of the retirement plan, so you need not concern yourself with diversification except as called for by your investment cycle.

You are, of course, subject to the prudent man rule. And we also expect you to keep the portfolio composed of securities that are reasonably marketable. Beyond these constraints, our objectives do not limit the kinds of securities you may hold. We ask, however, that you avoid any direct holdings of (the sponsor's) stocks, bonds, debentures, or other securities.

Exhibit 6: Investment Guidelines for a Large Company Equity Manager—A Manufacturing Company

A. Objectives

1. As a large company stock manager: To select from medium to larger sized companies those stocks which offer limited downside risk while at the same time providing the opportunity for superior long term returns. These results will be achieved through a disciplined, fundamental approach producing a high yield, low p/e portfolio.

2. To achieve an annualized return (net of all expenses and fees) above the S&P 500 Index return over a 3 to 5 year period.

B. Guidelines

1. Non-equity investments, restricted to cash instruments (maturity less than one year), are expected to average no more than 5% and should not exceed 10% of the account for an extended period without the prior consent of the Investment Committee.

2. No single equity issue should exceed 10% of the total portfolio.

3. The *portfolio* beta for equity holdings should normally range between 0.8 and 1.2.

4. Equity holdings should be reasonably diversified with a minimum of 50 holdings and a maximum of 75 holdings.

5. Excessive turnover should be avoided.

6. The Investment Committee should be advised promptly if any of the following events occurs:

   - a significant change in investment philosophy
   - a loss of one or more key people
   - a new portfolio manager(s) on the (sponsor's) account
   - any event that is likely to adversely impact to a significant degree the management, professionalism, integrity or financial position of (the investment manager).

Exhibit 7: Summary of Investment Manager Guidelines for an Optioned Equity Portfolio—A Service Company

Objective: Portfolio rate of return, net of fees, should exceed the rate of return of the performance standard.

Performance Standard: Annual return on 90 day Treasury bills + 350 basis points.

Permitted Investments: Domestic equities, put and call options on domestic equities, certificates of deposit, bankers' acceptances, repurchase agreements, Yankee CD's, Eurodollars CD's, commercial paper, trustee bank's short term investment fund.

Prohibited Investments: Securities issued by (the sponsor) or its subsidiaries.

Investment Restrictions: On average, at least 75% of the portfolio's market value shall consist of optioned equity positions or cash and equivalents. At the time they are written, at least 90% of the options must be either at-the-money or slightly out-of-the-money.

Security	Restrictions
All securities held	An investment in any single issue should not exceed 5% of the shares outstanding
Cash and equivalents	Standard guidelines

Exhibit 8: Investment Guidelines for an International Equity Manager—A Manufacturing Company

A. Objectives

1. As an active international equity manager: To implement an international equity investment program that places appropriate emphasis on market (country) and issue selection so as to maximize total return in U.S. dollar terms while minimizing portfolio risk by maintaining reasonable diversification.

2. To conduct intensive fundamental research so that, on average, medium and small size—as well as large—companies are well represented in portfolio holdings.

3. To achieve an average annual compound return, net of all taxes, fees and expenses, that exceeds the Capital International EAFE Index by at least 300 basis points over a market cycle (3 to 5 years). The Investment Committee assumes that achievement of this goal would place (the investment manager's) performance significantly above the median performance of a broad universe of managers of non-U.S. equities. The Committee acknowledges that the (investment manager) does not warrant or guarantee that such goal or the objective to maximize total return will necessarily be achieved.

B. Guidelines

1. The maximum weighting of any one country in the portfolio should not exceed 70%.

2. Equity exposure to at least 5 markets should be considered a minimum and only with the prior consent of the Investment Committee may less than 5 markets be represented in the portfolio.

3. Cash may be held in local currency at a maximum of 10% of the assets deployed in that market, except that a higher percentage may be held pending settlement of equity transactions.

4. U.S. Treasury bills and other short-term U.S. money market instruments may be used as a tool to preserve capital when market conditions so dictate but should not exceed 10% of assets under management for an extended period without the prior consent of the Investment Committee.

5. Hedging of an equity position in a market against the U.S. dollar is specifically authorized except that at no time shall (the investment manager) engage in currency speculation. Hedging against non-U.S. dollar currencies, except to cover the settlement of equity transactions, is subject to the specific approval of the Investment Committee.

6. Excessive turnover (i.e., turnover rates that are unusually high relative to the manager's historical experience and investment style) should be avoided. This guideline is especially important in view of the high transaction costs referable to non-U.S. equities.

7. No less than 25 issues should be included in the portfolio without the prior consent of the Investment Committee.

8. Only publicly traded equities, cash and cash equivalents should normally be held in the (sponsor's) portfolio. Investments in foreign fixed income securities (other than short-term money market instruments) should not be made without prior consent of the Investment Committee. Investments in equity and long-term fixed income securities of U.S. companies are prohibited.

9. The Investment Committee should be advised promptly if any of the following events occurs:
   - a significant change in investment philosophy
   - a loss of one or more key people
   - a new portfolio manager(s) on the (sponsor's) account
   - any event that is likely to adversely impact to a significant degree the management, professionalism, integrity or financial position of (the investment manager).

Exhibit 9: Investment Guidelines for Global Fixed-Income Managers—A Manufacturing Company

Within the parameters of prudent risk, your overall objectives as a fixed income investment manager of a portion of the (the sponsor's) Employee Benefit Funds are listed below in the order of priority:

- Preservation of Capital
- Long-run Rate of Return

The following parameters are applicable:

1. The reference currency of the portfolio is US Dollars.

2. Portfolio performance will be compared with the Salomon Brothers World Government Bond Index.

3. The portfolio may be invested in fixed and floating rate securities and deposits denominated in US Dollars or in any other freely convertible currencies.

4. There are no restrictions on the exposure of the total portfolio to any single currency and forward foreign exchange contracts related thereto.

5. The acquisition of zero-coupon and partly-paid securities will be permitted.

6. Investments will be restricted to those with S&P or Moody bond rating prospects of 'A' or higher, or the equivalent in the best judgement of the investment manager.

7. The maximum investment in the securities of any one borrower will be restricted to 10% of the total portfolio with the exception of the US, UK, Dutch, German, Japanese, Swiss, French, Australian and Scandinavian Governments or their agencies and Supranational borrowers.

8. The acquisition of securities will not result in ownership by the total portfolio of more than 5%* of any outstanding single issue.

*measured on an acquisition cost basis

No part of the fund shall be invested in any security issued or guaranteed by (the sponsor) or any of its subsidiaries. Commingled or pooled funds containing securities issued or guaranteed by (the sponsor) or any of its subsidiaries are acceptable if the total market value of such securities is less than 10% of the market value of the total commingled or pooled fund.

You are required to inform the (sponsor's) Pension Fund Trust and Investment Committee in advance, of any major change in your investment and portfolio strategy.

For the purpose of monitoring your overall performance, as required by ERISA, the Committee will utilize the annual and quarterly accounts of the Trustee and such additional reports and information as you are required to furnish pursuant to the provisions of your Investment Management Agreement.

The Committee reserves the right to revise the guidelines in the future as conditions may require.

Exhibit 10: Objectives for a Manager of Oil and Gas Properties—A Manufacturing Company

Mainly because of large holdings of fully participating annuities, we do not expect substantial benefit payouts will have to be made from the (sponsor's) trust fund for some years ahead. We therefore feel we can undertake the normal risk—and opportunity—of equity markets on this entire trust fund and still maintain a prudent balance in our overall pension assets.

Our objective for your account is that you build the highest long-term rate of total return you can through the following investments:

(1) Up to $30 million in the "Commingled Pension Trust Fund (Petroleum)" of (a bank).

(2) Up to $25 million in (a bank's) Petroleum Fund.

(3) Up to $30 million in one or more direct oil and gas investments.

Your account will at no time exceed 5% of the total assets of the retirement plan, so you need not concern yourself with diversification except as you may feel is appropriate within the asset class. We anticipate that you will seek investments with an expected return (IRR) of at least 10% real to the investor (after all costs and fees) in order to compensate for the illiquidity and risk inherent in oil and gas investments.

Exhibit 11: Performance Standards for Equity Real Estate Investments—A Manufacturing Company

1. Over periods less than one real estate market cycle, provide total rates of return in excess of the median of a universe of open-end and closed-end commingled real estate funds.

2. Over periods less than one real estate market cycle, produce an income (cash) return which is comparable to commingled real estate funds with similar investment characteristics.

3. Over a full market cycle (roughly a four-year period), provide a total rate of return that exceeds that produced by the Computer Direction Advisors Managed Real Estate Index by 200 basis points per year or more.

4. Over the longer term (i.e., period longer than a market cycle), provide a total rate of return premium of 4% over the inflation rate (as measured by the CPI).

5. Over periods longer than one real estate market cycle, maintain the volatility of the total rate of return at a level equal to or below that of the CDA Bank Managed Real Estate Index.

Exhibit 12: Summary of Investment Manager Guidelines for a Cash Reserve Account—A Service Company

Purpose: Receive fund contributions and income. Maintain liquidity to meet benefit and expense payments.

Objective: Maximize return from high quality short and intermediate term fixed income securities, while minimizing risk of principal loss.

Permitted Investments: U.S. Government and Agency securities, certificates of deposit, bankers' acceptances, repurchase agreements, Yankee CD's, Eurodollar CD's, commercial paper, medium-term notes, loan participations, corporate bonds and debentures, trustee bank's short-term investment fund.

Prohibited Investments: Securities issued by (the sponsor) or its subsidiaries.

Investment Restrictions:

Total Portfolio: Maturity structure dictated by fund contribution and withdrawal flows. All Fund income transferred to Cash Reserve Account. Committee periodically examines fund flows and determines additional amounts, if any, to be transferred to and from the account.

Security	Restrictions
All securities held	An investment in any single issue should not exceed 5% of the outstanding principal value of that issue.
Corporate bonds maturing in one year or longer	Rated A Standard & Poor's or A-2 Moody's. Subject to 5% rule.
Loan participations	Rated A-1 or A-2 by Standard & Poor's or P-1 or P-2 by Moody's. Subject to 5% rule.
Cash and equivalents	Standard guidelines.

Exhibit 13: Objectives and Guidelines for a Balanced Account Investment Manager—A Manufacturing Company

Authorized investments: Publicly traded, dollar denominated common and preferred stocks of companies with a minimum capitalization of $50 million; convertible bonds, government and agency bonds and notes, corporate bonds and notes, and mortgage-backed securities; short-term investments; foreign currency denominated bonds up to 10% of the fixed income portion of the account.

Portfolio objective: An annualized, total rate of return, over three year cycles, that exceeds a weighted index calculated as follows:

60% (S&P 500 + 2%) + 40% (Salomon Big + 1%)

Asset allocation: Asset mix is at the discretion of the Investment Manager, provided that equity investments shall be at least 20%, but no more than 80%, of the market value of the portfolio.

Risk parameters The historical beta of the equity portion of the portfolio, including cash, shall not exceed 1.25; no more than 10% of the total market value of the portfolio may be invested in bonds rated BAA or lower by Standard & Poor's or Moody's Investor Service.

Miscellaneous: a. It is not anticipated that any cash withdrawals will be necessary; therefore, there is no liquidity preference in this portfolio.

b. The equity holdings in this account supplement the fund's large, highly diversified core equity portfolio; therefore, the portfolio should be purposefully constructed as a less than fully diversified portfolio as measured either by the number of individual issues held or by the economic sector weightings of issues held.

c. The investment manager is encouraged to advise the (sponsor's) Investment Committee, if, at any time, these guidelines are in conflict with the manager's best investment judgment.

Exhibit 14: Investment Policy Statement for a Balanced Fund —A Manufacturing Company

The purpose of this investment policy statement is to establish a clear understanding of the investment objectives of (the sponsor) and will be used as a guideline for all investment advisors who manage its funds. This policy statement describes the performance standards that will be utilized by (the sponsor) in monitoring investment performance on a continuing basis.

Objectives

The primary objective of the investment for (the sponsor) is *to provide for preservation of capital with an emphasis on long-term growth without undue exposure to risk*. The objectives shall be accomplished utilizing a balanced strategy of fixed income, equities and cash equivalents in a mix which is conducive to participation in rising markets while allowing for adequate protection in falling markets. Due to the inevitability of short-term market fluctuations which may cause variations in the investment performance, it is intended that the following objectives will be achieved by the investment manager(s) over a *moving 3-year period*.

The investment objectives shall be as follows:

Equity Funds

1. The total return of the equity funds shall exceed the S&P 500 Index by 3% or more over a moving 3-year period and a full market cycle.

2. The volatility, as measured by "beta," of each equity manager shall not exceed 110% of the beta for the S&P 500 (as represented by 1.00).

3. Each investment manager is expected to produce a positive risk-adjusted return (alpha).

4. Each investment manager is expected to remain in the top quartile of the equity manager universe. During each "down market" period the manager is expected to be in the top 10% of this same universe.

Fixed Income Funds

1. The total return of the fixed income fund shall exceed the Shearson Lehman Intermediate Government/Corporate Bond Index by 1.0% or more.

2. The volatility, as measured by "beta," of each fixed income manager shall not exceed 110% of the beta for the Shearson Lehman Intermediate Government/Corporate Bond Index (as represented by 1.00).

3. Each investment manager is expected to produce a positive risk-adjusted performance (alpha).

4. Each investment manager is expected to remain in the top quartile of the intermediate fixed income investment manager universe.

5. Each investment manager shall maintain an *average* maturity for the entire portfolio of seven years or less. There is no minimum maturity restriction.

Asset Allocation

1. The asset allocation of the fund will be constantly monitored by (the sponsor). The asset allocation should currently reflect the following structure:

Type of Security	*Target*	*Range*
Equities	50	25-75
Fixed Income	20	20-50
Cash	30	5-30

2. Upon an examination of the historical relationship of risk and return among asset classes, (the sponsor) will determine that the asset mix should produce the highest probability of meeting or exceeding the fund's objectives. This current allocation will be under constant review to determine whether the mix is optimal. If any investment manager of this fund determines that it is in (the sponsor's) best interest to deviate from these ranges, the manager must first obtain approval from (the sponsor).

3. (The sponsor) believes that to provide superior investment results it is necessary for each investment manager to be aware of major trends developing in the equity and fixed income markets. While the company has no intention of playing an active role in specific investment decisions or becoming "market timers," it is important that each investment manager be prepared to help (the sponsor) take advantage of positive trends in the market and remain protected from the negative trends.

Investment Manager Guidelines

1. Each investment manager shall have the full investment discretion with regard to security selection and timing of purchases and sales.

2. For diversification purposes, (the sponsor) has determined that the equity portion of the portfolio should have in excess of 25 positions.

3. The performance of each investment manager will be evaluated on a quarterly basis to ensure that the fund's objectives will be accomplished. (The sponsor) will also require a high level of communication with each investment advisor as well as a continuity in personnel associated with the account either directly or as policy makers for the investment advisory organization.

Investment Manager Restrictions

1. There shall be no short-selling, securities lending, option trading, financial futures or other specialized investment activities without prior communication with (the sponsor).

2. There shall be no investments in non-marketable securities without prior communication with (the sponsor).

3. Each investment manager must assure that no position of any one issuer shall exceed 8% of the manager's portfolio, with the exception of securities issued by the U.S. government and its agencies.

4. There shall be no purchase which would cause a position in the portfolio to exceed 5% of the issue outstanding.

5. The bonds purchased must have a credit rating of investment grade or better by both Moody's and Standard & Poor's rating services.

6. Not more than $500,000 of an investment manager's portfolio shall be invested in commercial paper of anyone's issuer. Not more than $100,000 shall be invested in the bank certificates of deposit of any single issuer.

Investment Manager Review

This statement of investment policy shall be reviewed continually. The investment performance will be reviewed on a quarterly basis and the report will be provided by an independent third party. The managers will be welcome to provide any suggestions regarding appropriate adjustments in this statement or the manner in which investment performance is reviewed.

Exhibit 15: Investment Policy and Objectives for a Balanced Fund—A Manufacturing Company

Total Fund

The broad investment objective for the (company's) Retirement Fund is to at least maintain the purchasing power (defined as the inflation rate plus real wage gains) of the consistent plan assets through a program of investment—chiefly in common stocks. In addition, the fund has two specific objectives:

- to earn an average, annualized total return, in real terms (adjusted for the Consumer Price Index) of 6%—net of fees.
- to be in the top quartile of the SEI Large Plan Universe—Total Fund Segment—before fees.

Performance against these objectives is to be measured over running five-year periods. It is recognized that the real return objective may be difficult to attain in every five-year period, but it should be attainable over a variety of five-year periods.

To reach this objective the total (company) fund will be divided into three segments and reserve:

	Target
1. Equities	70%
2. Fixed Income	15%
3. Real Estate	10%
4. Reserve Fund	5%

Equity Segment

(The company) believes that common stocks offer the highest real returns over the long term. The Equity Segment will, therefore, include the largest proportion of fund assets—approximately 75% of total fund assets at market value. Although the actual percentage of equities and equity reserves will fluctuate with market conditions, levels in excess of 80% will be closely monitored, and sales will automatically be implemented when the ratio exceeds 85%. These ratios may be changed from time to time, but it is anticipated that such changes will be infrequent.

The specific objectives of the Equity Segment of the (company's) Fund are:

1. to achieve a real 7% annualized total rate of return—net of fees;
2. to outperform the S&P 500 Index—net of fees;
3. to be in the top quartile of the SEI Large Plan Universe—Equity Segment—before fees.

These objectives are to be measured over running five-year periods. The Equity Segment will be managed by external firms using a variety of active management techniques. Such managers will normally invest in domestic common stocks. They may, however, at their discretion hold investment reserves of money market instruments or bonds—with the understanding that performance will be measured against the S&P 500 Index and against other common stock managers with similar styles.

Equity Segment assets will also be allocated to separately managed portfolios of small growth companies (up to 5% of total market value), foreign securities (up to 10% of market value), venture capital (up to 5% of total market value), and/or other asset classes which may be added in the future. These ratios are subject to change, but changes are expected to be infrequent.

Fixed Income Segment

The purpose of the Fixed Income Segment is to provide a hedge against deflation. This segment should normally represent approximately 15% of the total fund assets at market value. Although the actual percentage will fluctuate with market conditions, levels in excess of 20% or below 12% will be monitored closely, and additional funds will be transferred as needed to ensure that the ratio does not fall below 10%.

U.S. money market instruments as well as U.S. bonds may be used without limitation in the Fixed Income Segment, but equities and convertible bonds are not permitted. The Fixed Income Managers are expected to employ so-called active management techniques such as interest rate anticipation and inter-sectoral arbitrage, but changes in average maturity should usually be moderate and incremental. Since the fund is designed as a deflation hedge, an average maturity of less than 5 years would rarely if ever be appropriate. In addition, call protection and high quality (on average AA) should be emphasized.

The investment objective of the Fixed Income Segment is to outperform the Shearson/Lehman Brothers Intermediate Term Index. This would be measured net of fees over running five-year periods. Although not an objective, it is expected that the Fixed Income Segment would achieve an annualized real return of 2-3% and would outperform the median of the SEI Large Plan Universe—Fixed Income Segment over an interest rate cycle—normally 3-5 years.

Permissible Assets

With respect to both common stock and fixed income managers, the use of options and futures, individual security selection, security size and quality (except bonds in the Fixed Income Segment), number of portfolio industries or holdings, current income levels and turnover are left to broad manager discretion, subject to usual standards of fiduciary prudence. One exception is that private placements of any kind, including direct mortgages, may only be purchased in the Fixed Income Fund—subject to a 15% limitation.

Real Estate Segment

The Real Estate Segment is designed to provide a hedge against high inflation. It should, therefore, be composed of rental properties, purchased at reasonable prices with short or intermediate-term leases or escalators. It should normally represent approximately 10% of the total fund assets at market value. Although the actual percentage of real estate equities will fluctuate with market conditions, levels in excess of 13% will be closely monitored and will result in a termination of any cash flow to this area.

The investment objective of the Real Estate Segment is to outperform the Lewis, Bailey Real Estate Median over running five-year periods. In addition, though not an objective it is expected that this segment would achieve a 3-4% annualized real return over an annualized 3-5 year period.

Cash Flow

Cash flow will generally be used to rebalance the total fund asset mix in the direction of the basic ratios.

Monitoring

Both the total fund and the individually managed portfolios will be monitored on a continual basis for consistency in each manager's investment philosophy, return relative to objectives, investment risk as measured by asset concentrations, exposure to extreme economic conditions, and market volatility. Portfolios will formally be reviewed on a quarterly basis, but the results will be evaluated on a running five year cycle.

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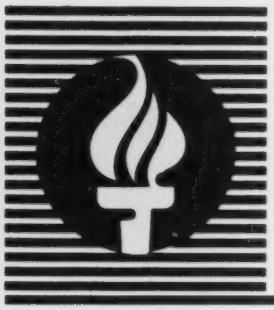

The Conference Board

Rating Corporate Finance and Accounting Units

- *CEOs and top management are key watchdogs*
- *most measures are subjective; 26 indicators used*
- *objective criteria focus on company-wide results and departmental management*
- *most firms complying with Treadway guidelines*

Research Bulletin No. 224

Method

A survey questionnaire regarding corporate finance and accounting practices was mailed to the chief executive officers of 500 large nonfinancial firms in the U.S. and Canada. Altogether, 113 usable replies were received. The distribution of responding firms by line of business was:

Manufacturing companies (durable goods)	35
Manufacturing companies (nondurables)	26
Non-manufacturing companies	52
Total	113

The distribution by annual sales:

$5 billion and over	29
$1 billion to $5 billion	4
$500 million to $1 billion	23
$100 million to $500 million	19
Less than $100 million	1
Total	113

Fifty-seven of the 113 questionnaires were answered by chairmen or presidents. These corporate leaders brought varied backgrounds to their present positions. Here are the principal fields of specialization through which they rose to the top spots:

Marketing	20
Finance	12
Manufacturing	9
Engineering	5
Legal	4
Operations	2
Retail operations	2
Other (product development, planning and operations, engineering and operations—1 each)	3
Total	57

The remaining 56 questionnaires were returned by executives having the following titles:

Chief financial officer	22
Other financial officer (e.g., treasurer, controller)	14
Other (e.g., vice chairmen, executive VPs, vice presidents with unspecified responsibilities, director of internal auditing, financial analyst)	20
	56

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Rating Corporate Finance and Accounting Units

by Francis J. Walsh, Jr.

The corporate financial function—and its key role in financial accounting and reporting—is under increasing scrutiny both from within *and* outside the company. Recognition of the influence that finance and accounting can have on a firm's profitability and the attainment of its strategic goals and public demands for greater reliability in financial reporting, are behind this growing interest. And some observers believe it will intensify if the recent recommendations of the National Commission on Fraudulent Financial Reporting (the Treadway Commission) become law.

This study shows how the top management of 113 leading U.S. and Canadian corporations is dealing with some thorny issues in financial management and accounting. Specifically, the study addresses and analyzes corporate response to the following questions, which were posed in survey form:

(1) How do chief executives and members of the board of directors know whether the finance and accounting function is successful (as distinct from the performance of the executives in charge of them)? What are the criteria for success?

(2) What, if any, quantitative measurements are appropriate for gauging the effectiveness of finance and accounting activities?

(3) What effects do finance and accounting have on the overall success of the corporation? Do they, for example, directly influence the setting and attainment of broad, strategic objectives?

And, recently, a fourth question in this vein has emerged:

(4) What effects are the Treadway Commission's recommendations having on corporate finance and accounting activities?

Highlights

- Nearly all of the 113 survey respondents believe the finance and accounting function can be measured or evaluated in terms of overall performance and effectiveness. And over 80 percent attempt to do so. Those who do not do so frequently cited a lack of objectives, standards, or criteria.
- Two-thirds of the 93 companies that endeavor to gauge and evaluate rely on a combination of subjective judgment and quantitative measurements, with non-quantitative considerations predominating. The most frequently cited test was effectiveness in providing clear, timely, and high-quality external financial statements, management reports, analyses, and projections, and related information. Comments by internal and external auditors and the absence of problems and unwelcome "surprises," such as unexpected losses or liabilities, were also cited as viable criteria.
- Surveyed firms rely on two broad types of quantitative measures:

(1) Indicators of how well the finance and accounting unit itself is doing, including comparisons of actual performance with budgets and plans, and the number of audit adjustments.

(2) Those measures concerning the financial condition and results of the company as a whole that are directly or indirectly influenced by the financial function. This group includes measures that relate to financing and investment.

- More than eight out of ten of the surveyed companies already comply with many of the major recommendations of the Treadway Commission. For example, they evaluate the financial management and accounting function in terms of its ability to prevent or detect fraudulent or misleading financial reporting. To do so, most firms rely heavily on a comprehensive auditing system: a strong internal auditing program, checking by outside auditors, and an active audit committee of the board of directors. Other frequently cited precautions include careful review of the company's system of internal control and monitoring by senior management.
- The corporate finance and accounting function has many watchdogs. But the top five, according to survey participants, are the chief executive officer, the audit committee of the board of directors, internal auditors, outside auditors, and the full board of directors.
- Opinions vary on the issue of whether the financial function does—or should—play a principal role in setting and attaining broad strategic objectives. Among the 91 surveyed executives who provided information on this point, 51 stated that the financial function in their companies is a leader in pointing out strategic opportunities and recommending changes in strategy. Thirty-seven, on the other hand, report that the financial function primarily reacts to opportunities identified by other units or executives.

Related Conference Board Research

Audit committees of the board of directors and corporate internal auditing programs are topics that are closely related to the subject matter of this report. Two Conference Board publications in these areas—"Corporate Directorship Practices: The Audit Committee," Report 766, 1979; and "Internal Auditing," Report 748, 1978—are currently being updated. The new edition on the audit committee is scheduled for publication before the end of 1988. The report on internal auditing will appear in 1989.

Evaluation Techniques

The corporate financial organization is sometimes called the chief scorekeeper, as it often rates or measures the performance of other units. All but two of the 113 survey participants believe that the financial organization itself can also be measured or evaluated. Somewhat fewer, 93 executives, reported that their companies actually attempt to do so. (Eighteen do not and two declined comment.)

Two-thirds (60) of the companies that rate their financial units rely on a combination of subjective judgments and quantitative measurements. Only eight of these utilize primarily quantitative standards; while 19 rely mostly on the personal judgment of a key executive or independent evaluator. Six did not comment. In one executive's opinion, "the financial management and accounting function can be qualitatively evaluated but not 'measured.' The significant portion of its effort that is mandated by law or regulatory requirements prevents the latter."

Non-Quantitative Criteria

Twenty-six different non-quantitative or subjective considerations were named by the survey participants as standards by which they judge the effectiveness and success of their finance and accounting operations. The following 11 stand out, however, because of how frequently they were mentioned:

	Number of Mentions
- Effectiveness in providing quality financial statements, management reports, analyses, projections, and related information in a timely, accurate, thorough, helpful, and understandable way.	20
- Nature and extent of opinions and comments by internal and outside auditors.	16
- Absence of problems and "surprises," such as repeated audit disclosures of the same problems, unexpected losses or liabilities, and numerous audit adjustments.	14
- Quality, stature, and professional competence of personnel; morale of the unit; effectiveness of management development.	10
- As part of the management team, responsiveness to and understanding of the needs of other company units; effectiveness of communications within the company.	9
- Quality of financial and accounting controls.	8
- Quality of relationships with commercial banks, rating agencies, and the investment community, and their perception of the company and its financial management.	7
- Comparisons with other companies, e.g., by outside directors and independent auditors.	7
- Knowledge of the current financial climate, issues, and opportunities; creativity and innovation in providing financing.	7
- Ability to provide financing when needed and at reasonable cost.	4
- Ability to attain goals and objectives.	4

Base: 113 companies

Fifteen other subjective evaluation standards received occasional mention. They are:

- Effectiveness in problem solving.
- Effectiveness in helping to plan and run the business.
- Effective use of computer technology.
- Successful handling of tax matters.
- Accuracy of billings to customers.
- Promptness in paying bills.
- Results of FCPA Compliance reviews.
- Improvements over time.
- Customers' and vendors' perceptions.
- Effective handling of foreign currency problems.
- Successful relationships with regulatory commissions.
- Observance of company's code of conduct.
- Outside directors' perception.
- Tightness of the budget process.
- Observance of new accounting standards.

There are many variants in this process. A company in the chemical industry, for example, has an unusual, "market-oriented" approach to evaluating the effectiveness of its financial organization. One of its executives explains: "The company's business units are given wide latitude to set quality and service levels for the services they 'purchase' from the financial function; including the option of purchasing such services from outside vendors. Financial function performance is therefore reflected in the degree to which its services are subscribed to by those who pay for them."

The finance and accounting function has traditionally been assigned the role of detecting, and better still of preventing, misrepresentation in financial reports. However, this role, and the effectiveness with which it is performed, recently gained in importance on a national scale as a result of the work of the Treadway Commission. A separate discussion of the detection and prevention issue appears on pages 5-8.

Quantitative Measurements

Only eight companies in the survey rely primarily (or exclusively) on quantitative tools to measure the effectiveness

Why Some Companies Do Not Rate Their Finance and Accounting Operations

The 18 survey respondents whose companies do not attempt to rate their finance and accounting operations offered a variety of explanations. The most frequently cited was lack of objectives, standards, or criteria. Another observation was that some top managements are simply preoccupied with other matters. As one executive observed: "Company reorganization and expansion into other industries have taken priority." Or as the president of a utility company observed, "The question for us is whether it is worthwhile after normal inside and outside auditor reviews." Problems in sorting out cost-benefit issues and a lack of time or other resources were also cited.

Some executives opt not to rate because they believe that overall company performance reflects the effectiveness, or lack thereof, of the financial management function. Several of these respondents also rely on the performance reviews of individual financial executives for indications of the quality of the function.

of their financial management and accounting activities. But, as noted, many others use them to some extent. These indicators fall into two general categories: (1) Measurements concerning the financial condition and results of the company as a whole that are directly or indirectly influenced by the financial function, (2) indicators related to the management of the finance and accounting unit itself.

The following company-wide measurements[1], were mentioned by surveyed executives:

- Asset utilization indicators, such as minimization of cash balances, cash flow measurements, and tracking of inventory levels and trends.
- Cost of capital and effective interest rates on debt.
- Maintenance of a specified debt rating.
- Effective tax rates.
- Performance of short-term investments and pension fund assets.
- Ratio analysis, including return on investment, interest cost as a percentage of assets, and financing costs as a percentage of sales.
- Indicators of receivables management, e.g., bad debt percentage, accounts written off, past-due accounts, and days sales in receivables.
- Indicators of company work force size, including employee headcounts, payroll costs per employee, and productivity statistics.
- Comparisons of actual performance of the company as a whole with budgets and plans.
- Comparisons with peer companies by means of statistics provided by public accounting firms and with data obtained from outside directors.

In gauging the performance of finance and accounting as a unit of the company,[2] the survey participants cited comparisons of actual performance with unit budgets and plans as the most used indicator. The number of audit adjustments and of negative comments in audit reports were also mentioned frequently. Cited rarely were:

- Departmental employment statistics, such as headcounts, turnover, and productivity (e.g., cost of processing accounts payable).
- Cost comparisons with other companies.
- Cost effectiveness of the unit, including the ratio of the function's cost to company sales.

The Influence of the Treadway Commission

The 1987 report of the National Commission on Fraudulent Financial Reporting aroused considerable interest among executives concerned with the problems of evaluating the finance and accounting function.[3] The group, nicknamed the Treadway Commission, after its chairman, James C. Treadway, Jr., a former SEC member, was a strictly private-sector attempt to "consider the causes and effects of fraudulent financial reporting and the extent to which it can be prevented and detected." The Commission, which was sponsored by a group of the leading accounting and financial management societies, also examined the roles of internal and outside auditors and considered the "attributes of corporate structure that might contribute to fraudulent reporting or to failure in detection."

The Commission's final report contained a number of recommendations, not only for public companies (summarized in the box on pp. 6-7), but also for independent public accountants, the SEC, and educators. The recommendations, which have stimulated a great deal of discussion, are primarily designed to make the occurrence of fraudulent financial reporting less likely and its detection easier.

[1]For a more extensive treatment of performance measurements, see the following Conference Board publications: Francis J. Walsh, Jr., *Measuring Business Performance*, Research Bulletin No. 153, 1984. Francis J. Walsh, Jr., *Measuring Business-Unit Performance*, Research Bulletin No. 206, 1987.

[2]The Management Accounting Practices Committee of the National Association of Accountants is currently working on a project to assist its members in measuring and evaluating the controllership function. A Statement on Management Accounting is expected to result from this project some time in 1989 and it will contain self-diagnostic guidelines for the controllership function. The Association is located at 10 Paragon Drive, Montvale, New Jersey 07645-1760.

[3]The *Report of the National Commission on Fraudulent Financial Reporting* was released in October 1987 and is available from the American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, New York 10036-8775.

Treadway Commission

Recommendations for the Public Company

The Commission concluded that each public company is primarily responsible for preventing and detecting fraudulent financial reporting. For those companies, the Commission developed a series of recommendations designed to make the occurrence of fraudulent financial reporting less likely, and make the detection of any occurrence more probable. These recommendations are based largely on practices many companies already follow. The Commission recognizes that for those companies these recommendations merely confirm the value of current practices.

The Tone at the Top

The Commission believes the most important factor in preventing fraudulent financial reporting in any public company is the company's "tone at the top." In other words, a visible interest by management and directors in ethical behavior and strong controls will permeate the organization and limit the risk that fraud will occur. To "set the right tone" in a public company, the Commission recommends:

- Management should perform an ongoing fraud-risk assessment. This risk assessment process enables the company to develop internal controls that minimize the risk of fraudulent financial reporting. Further, this process should be a continuing part—and not just a discrete, one-time endeavor—of the internal control system throughout all levels of the organization. In an appendix to its report, the Commission provides guidelines for assessing the risk of fraudulent financial reporting.
- All public companies should maintain internal controls that provide reasonable assurance of the prevention or early detection of fraudulent financial reporting. The Commission stressed that a strong control environment is an important element in every company's control system. The control environment consists of such things as "management philosophy and operating style, organizational structure, methods of communicating and enforcing the assignment of authority and responsibility, and personnel management methods." The Commission stressed that effective controls are a company's best defense against fraud, and that each company must continually evaluate and design controls responsive to its unique situation. No standard set of controls is appropriate for all companies.
- All public companies should establish effective written codes of conduct. While individual corporate codes of conduct can and should vary, such codes should—at a minimum—contain clear guidelines on (1) conflicts of interests, (2) compliance with domestic and foreign laws, and (3) confidentiality of proprietary information.
- All public companies should maintain accounting functions that are designed to meet their financial reporting obligations and the Chief Accounting Officer has the the primary responsibility for designing, implementing and monitoring the company's financial reporting system and internal accounting controls.
- The SEC should require that management acknowledge in the annual report to shareholders its responsibility for the financial statements and internal controls. Management should discuss how these responsibilities are being met and assess the effectiveness of the company's internal controls. The Commission provides guidance for preparing management's report in an appendix to its report.

The Internal Audit Function

The Commission believes that all public companies should have effective internal audit functions that meet the standards prescribed by the Institute of Internal Auditors. Recognizing that some smaller companies could not employ persons to serve exclusively as internal auditors without hardship, the Commission contemplates that internal auditors may not function exclusively in that capacity and that outside auditors may perform certain internal audit functions. Regarding internal audit, the Commission recommends:

- The director of internal audit should have unrestricted and direct access to both the audit committee and the CEO. To be effective, the internal audit function must be independent and objective. The Commission recommends that the internal audit function report administratively to a senior officer not directly responsible for the financial statements.
- Internal audit should coordinate its work with the independent public accountants. The Commission also believes that internal audit should increase its financial auditing responsibility, particularly at the corporate level.

The Audit Committee

The Commission believes that all public companies should be required by the SEC to have audit committees composed of independent directors. It emphasizes the need for the audit committee to exercise vigilant and informed oversight of the financial reporting process, including the company's system of internal control. In an appendix to its report, the Commission provides guidelines for audit committees. Regarding audit committees, the Commission recommends:

- The board of directors of every public company should develop and approve a written charter delineating the audit committee's duties and responsibilities.

- Audit committees should review the independence of the independent public accountant. Audit committees also should review management's evaluation of this independence and, before the beginning of each year, should review management's plan for engaging independent auditors to perform management advisory services.
- The SEC should require that the annual report to stockholders include a letter from the audit committee chairman describing the committee's responsibilities and activities during the year.
- Audit committees should monitor compliance with company codes of conduct as part of their ongoing oversight of the effectiveness of internal controls.
- Audit committees should have resources necessary to fulfill their role. The Commission suggests that the internal audit function can be a valuable source of information and staff for the audit committee.
- The audit committee should oversee the quarterly reporting process. This oversight would include reviewing controls that management has established over the quarterly reporting process, and communicating with senior management, the chief internal auditor, and the independent public accountants.
- Audit committees should monitor instances where management seeks second opinions on significant accounting issues. The Commission believes that management has the legitimate right to seek second opinions from independent public accountants. However, because the potential for abuse exists in these situations, management should explain to the audit committee why a particular accounting treatment was chosen.

Standards for Internal Control

The Commission recommends that its sponsoring organizations set up an interdisciplinary body to integrate internal control concepts and develop a common reference point. Currently, varying interpretations and philosophies on internal control exist, which causes managements, independent public accountants, and internal auditors to disagree sometimes about the adequacy of internal controls. The Commission believes common standards for internal control would help public companies evaluate and improve their internal control systems.

Source: This section is reproduced from the "Report of the National Commission on Fraudulent Financial Reporting: an Executive Overview," October 1987, prepared by Ernst & Whinney, Cleveland, Ohio.

Because many of the Commission's recommendations directly relate to the effectiveness of the corporate finance and accounting function, survey participants were asked whether their companies currently *evaluate* the function in terms of its ability to prevent and detect fraudulent or misleading financial reporting. The answer: all of the 93 firms that evaluate their finance and accounting function test for effectiveness in preventing and detecting fraud. Not surprisingly, most respondents (74 out of the 93) reported that they used outside and internal auditors for this purpose. A third (31) also mentioned the involvement of the board of director's audit committee or other outside directors.

The system of internal control is perhaps the most important element in the financial function's success in safeguarding the accuracy and reliability of financial reports. Because the volume of transactions—even in organizations of modest size—is so great, no amount of auditing can possibly examine more than a small percentage. Consequently, all auditors study and test internal control systems to gauge whether accounting records—and the financial statements prepared from them—are reliable. There are many elements of internal control—e.g., organization charts, policy statements, procedure manuals and other documentation, separation of duties, cross-checking of results, budgets, audits, follow-up of reported exceptions, and analytical reviews. A total of 22 survey participants reported reviewing and evaluating their internal control mechanisms. A closely related category is direct observation of the finance and accounting function by senior nonfinancial executives. Such supervision was mentioned by 13 respondents.

Conducting detailed financial reviews—e.g., comparisons of actual results with budgets, with operating information, and with other companies, and account reconciliations—can indicate that something is wrong with the financial statements. For example, deviations of current numbers from past or expected performance invariably require investigation and satisfactory explanations. Eight firms conduct such reviews. Codes of conduct, including required certificates of compliance, e.g., with accounting requirements of the Foreign Corrupt Practices Act, were also cited by six participants as a means of preventing fraudulent financial reporting. Less popular methods included: prosecuting when fraud is detected; in-house peer reviews; obtaining the opinion of investment and commercial bankers; top management efforts to assure an atmosphere of integrity; following up complaints; strong CEO involvement in internal auditing; performance reviews of key financial and accounting personnel; and monitoring quantitative data, as, e.g., the number of audit corrections and errors in billing reported by customers.

An example of a comprehensive program to evaluate the finance and accounting function in terms of its ability to present and detect misleading financial reports is described by the chairman of an automobile products company in the box on p. 8.

A CEO Describes His Company's Program for Evaluating Its Financial and Internal Control System

"The company has a long-established philosophy that stresses the importance of strong financial and internal control. Substantial effort is directed to the administration of controls to prevent or detect fraudulent or misleading financial reporting. The effectiveness of the control system is evaluated in a variety of ways—some internal (self evaluation) and some external, as follows:

Written Finance Policies and Procedures—The company has published explicit financial policies and procedures covering accounting and internal control that establish corporate standards. Further, the company has a well-defined delegation of authority. Compliance with these requirements is evaluated in the course of internal and external audits. Also, controller's offices are established as part of every business and operation in the company and they are responsible for maintaining self-examination programs to verify compliance with the company's accounting and internal control policies.

Internal Auditors—The company has a professionally staffed internal audit function and well-developed audit programs. Audit coverage is comprehensive, is closely coordinated with the scope of outside auditors, and is planned based on risk analysis. Reports on audits conducted identify accounting and control weaknesses and audit ratings are assigned reflecting the overall quality of compliance and control in those areas reviewed. Action plans are monitored to ensure that deficiencies are corrected. The auditor meets regularly with and prepares reports to the audit committee. Quality assurance is maintained within the audit staff through training, audit program planning and evaluation, and workpaper and audit report reviews.

Outside Auditors—The audit firm is one of the Big Eight and is knowledgeable about the company and its finance policies and procedures. Management letters are sent to the company to report on exceptions found in the course of audits. The partner-in-charge meets regularly and reports to the Audit Committee on major accounting and control issues.

Budget and Financial Forecasting and Reporting Systems—Budgets are prepared by operations and staffs to control profits, costs, manpower, and capital spending. Projected and actual results are compared with budgets to measure and evaluate performance. Management reporting with explanations of variances provides the basis for continuous control over the business and the quality of accounting data.

Audit Committee Review of Accounting Procedures and Financial Controls—A variety of financial and control-related topics, including coverage of financial statements and 10K reports, are presented to the committee. Presentations are made by various members of financial management who serve to keep the committee informed on accounting and control issues. These presentations also allow the committee to evaluate the capabilities of finance personnel."

Despite their best efforts, however, some surveyed executives acknowledged that no financial reporting system is completely foolproof. As the CEO of an energy company commented:

> "Because of the nature of the function, the evaluation process is inexact. Nevertheless, it must be performed with as much objectivity as possible. We look at incisiveness of reports, understandability, meaningfulness, timeliness and accuracy."

Another chief executive takes a dim view of efforts to guarantee certainty in the financial reporting area. In his words: "One evaluates accounting practices and internal control procedures. This helps to ensure honest, ethical financial reporting. However, one can *never* entirely prevent and detect fraud, etc., as long as there are dishonest, crooked people and collusion in high places."

Who Judges the Financial Function?

Financial and accounting executives in the surveyed companies have a lot of people looking over their shoulders. As the box on page 9 shows, the chief executive officer, the audit committee of the board of directors, the internal auditors, and the outside auditors are the most frequently mentioned overseers. A common pattern, of course, is for a company to give both its internal and external auditors access to an audit committee of the board of directors. Meanwhile, as for all other major corporate activities, the CEO exercises general supervision over the finance and accounting function.

Many executives and accountants believe that the quality of evaluation of the function is related to the degree of independence of the internal auditors. Of the 74 firms that reported using internal auditors as evaluators of finance and accounting activities, 41 have these evaluators report to someone other than a financial executive. This reporting relationship is in marked contrast with past practice, where the internal auditors usually reported to a financial executive—often the controller.

Another factor tending to strengthen the evaluation process is the growing influence of the audit committee of the board of directors, which is often required by its charter to look into the quality and effectiveness of the company's financial and accounting operations. The following are excerpts from audit committee charters illustrating this responsibility. The audit committees should:

> "Receive and review the assessment of management and the internal auditors as to the quality and depth of staffing in the accounting and financial departments."

"Evaluate the adequacy and effectiveness of the corporation's accounting policies and procedures as well as financial and accounting management through observation and discussions with the independent accountants, internal auditors, and appropriate officers of the Corporation."

"Inquire into the effectiveness of the company's financial and accounting organization through discussion with the independent auditors and appropriate officials of the company."

Meetings held by audit committees in which they interview separately and privately the outside auditors, the internal auditors, and executives of the company are an important element in the audit committees' efforts to carry out their duties. This approach was specifically mentioned by 33 of the survey participants.

Outside auditors prepare, in addition to their standard opinion on the overall fairness of the company's financial statements, a letter containing various recommendations to management and the audit committee. This document, commonly called the "Management Letter," discusses conditions encountered by the auditors during their examination, which—while not serious enough to require a qualified opinion—are indicators of potential weaknesses in internal control. Such letters contain recommendations for correcting the conditions and are considered by audit committees in their evaluation of the financial management and accounting function. Often, the company's financial and accounting executives are expected to respond to the auditors' recommendations—either by assenting to them or by stating why they should not be adopted (e.g., because the cost of the recommended safeguards would be excessive compared to the benefits).

Individuals and Groups Who Evaluate the Effectiveness or Performance of the Corporate Finance and Accounting Function

	Number of Mentions
Chief executive officer	79
Audit committee of the board	75
Internal auditors	74
Outside auditors	55
Full board of directors	28
Chief financial officer	6
Regulatory agencies (e.g., public utility commissions)	2
Operating management	2

The following were mentioned once:

- Chief operating officer
- Top management (unspecified)
- Clients (engineering and construction company)
- Internal audit committee of management
- Vice chairman
- Financial community
- Finance committee of the board
- Outside survey

Base: 113 companies

The Strategic Role of the Financial Function

Questions are sometimes raised concerning corporate activities, like finance and accounting, that essentially provide supporting services to top management and to the operating units of their companies. Should such activities influence the overall direction of the corporation? Should finance and accounting, for example, have a role to play in setting and attaining broad strategic objectives? Does it?

To address these issues, the survey participants were asked for a general description of the role of the financial function in setting the strategic direction of their firm. The choices they were given and their responses follow:

	Number of Responses
The financial function is a leader in pointing out opportunities and recommending changes in corporate strategy.	51
The financial function primarily reacts to opportunities pointed out by other units or executives.	37
Combination of both.	3
TOTAL	91

Many of those characterizing the financial function as a leader in setting strategy emphasized that this involves a team effort, sometimes bringing together the chief financial executive, the treasurer, and the controller. As the CEO of a medical services firm noted, "Co-leader would be a more appropriate term. The financial function is an important, integral part of the overall team." A company president added: "Our strong, aggressive chief financial officer is a member of the senior management group that meets weekly."

Among the participants who chose the "reactor" alternative there seems to be a strong belief that this *is* the proper role for finance. For example, the president of a technology products company declared, "The primary responsibility for setting the strategic direction rests with general management, with support from marketing and technology. The role of the financial function is to support the planning process and execution of plans, including providing the necessary capital." Noted a utility company executive: "For the most part our financial functions only serve to record historical data." The

personalities and values of the top people in the company are also important determinants. For example, a financial executive of a retail chain observed, "My company's president and CEO are 'merchants,' as were their predecessors. They do not believe that any other area is relevant to running the company."

Those who viewed their company's financial function as playing a mixed leadership-reaction role see a trend developing toward leadership. As the CFO of a defense contractor reports, "The financial function is being rebuilt and is expected to be a full participant in determining strategy. It is presently involved but to an inadequate degree." An executive of a chemical company concurred, "On balance, the financial function generally plays a supporting role in the development of business strategies, rather than an out-front leadership role. However, the function's role in this area is mixed across the corporation (depending on the business unit and the working relationships of the individuals involved), and the trend is to become more pro-active."

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